BEFORE THE ARIZONA CORPORATIO.

Arizona Corporation Commission
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IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC 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. R14-2-1061 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

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PG&E ENERGY SERVICES CORPORATION'S POST-HEARING BRIEF

Pursuant to R14-3-109(R) of the Commission's Rules of Practice and Procedure, and the Chief Hearing Officer's directive, PG&E Energy Services Corporation ("PG&E ES") hereby submits its Post-Hearing Brief in the above-captioned proceedings.

I.

THE "PUBLIC INTEREST" REQUIRES THAT CERTAIN PROVISIONS OF THE SETTLEMENT AGREEMENT BE DELETED IN THEIR ENTIRETY AS A MATTER OF GENERAL REGULATORY POLICY AND LAW.

A. Introduction:

The settlement agreement improperly attempts to bar this Commission from exercising its regulatory oversight responsibilities. Section 6.1 of the May 14, 1999 Settlement Agreement ("Settlement Agreement") provides as follows:

> "...Approval of this Agreement by the Commission shall make the Commission a party to this Agreement and fully bound by its provisions." [emphasis added]

In addition, Section 6.2 further provides as follows:

> "...Neither the [signatory] Parties nor the Commission shall take or propose any action which would be inconsistent with the provision of this Agreement. All Parties shall actively defend this Agreement in the event of any challenge to its validity or implementation." [emphasis added]

As will be noted in the following discussion, these provisions are fraught with potential consequences severely adverse to the public interest and the Commission's ongoing ability to discharge its constitutional and statutory responsibilities.

B. Background:

Arizona courts have ruled that the Commission's agreement in a settlement not to take certain action is binding on the Commission in accordance with the terms of the settlement agreement. Illustrative in this regard is the 1996 decision of the Arizona Court of Appeals in U.S. West Communications, Inc. v. Arizona Corporation Commission, 185 Ariz. 277 (App.), 915 P.2d 1232 (1996). Therein the Court ruled that the Commission violated the terms of a 1988 settlement agreement it had entered into with U.S. West's predecessor (Mountain Bell) when the Commission imputed income from an unregulated affiliate of U.S. West to U.S. West in connection with its disposition of a 1993 rate increase application.

More specifically, U.S. West argued on appeal that only $43,000,000 of its affiliate's profits could be imputed as operating income revenues to U.S. West for rate making purposes. In the proceeding below, the Commission's staff had recommended an imputation of $60,684,000, attributing to U.S. West all of its affiliate's profits that exceeded the 11.4 percent rate of return that would have been permitted had the affiliate remained a regulated entity. The Commission adopted the staff's recommendation, as well as its rationale that U.S. West rate payers should receive the same benefit they would have had the directory publishing business not been transferred to the affiliate in 1988.

The following excerpts from the Court's opinion clearly indicate, by way of analogy, the potential significance of the above-quoted language from Sections 6.1 and 6.2 within the context of the instant proceedings:

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"...We consider whether, in so doing, the Commission violated the terms of the 1988 settlement agreement."
Ibid at 280

* * *

"...Under the terms of the settlement, the Commission agreed to "take no further action to challenge" Mountain Bell's transfer of yellow pages assets to USWD."
Id. at 280.

* * *

"Accordingly, because the Commission relied on a methodology that its 1988 agreement renders invalid, and because the staff introduced no evidence that would support a greater imputation under the proper [i.e. 1988 agreement] methodology, we set aside the Commission's greater imputation and direct it on remand to impute only $43 million of directory revenue."
Id. at 281-282

C. Discussion:

When read in conjunction with several other provisions of the Settlement Agreement the effect of the above-quoted language of Sections 6.1 and 6.2 would be to "handcuff" the Commission, and deprive it of its otherwise legal right to subsequently remedy or eradicate anti-competitive circumstances and effects which might become apparent as the Settlement Agreement is implemented. The following examples readily demonstrate this point.

Section 2.8 of the Settlement Agreement provides that

> "...Except for the changes otherwise specifically contemplated by this Agreement, unbundled and Standard Offer rates shall remain unchanged until at least July 1, 2004."[1]

Section 2.5 contemplates the possibility of future changes in rates and terms and conditions of service prior to that date, provided such changes

> "...[do not] materially modify the tariffs or increase the rates approved in this Agreement."

[1] These "changes" would appear to be in the nature of the types discussed in Sections 2.5, 2.6 and 2.8 of the Settlement Agreement. As such, they are not relevant to the corrective or remedial powers of the Commission here under discussion.

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Thus, in the event the Commission should determine subsequent to its approval of the Settlement Agreement that Arizona Public Service Company ("APS") had improperly allocated costs in its design of the "shopping credit" and/or unbundled rates so as to disadvantage new entrants in the competitive retail electric market, the Commission would be legally precluded from undertaking any corrective action prior to July 1, 2004 by reason of its status as a party to the Settlement Agreement. Moreover, any attempt on its part to assert that such relinquishment of authority was not intended would not be governing. For, as the U.S. West Court observed

> "...Because interpreting the agreement is a question of law for the Court and not a discretionary matter constitutionally entrusted to the Commission, we owe no deference to the Commission's interpretation."
> Id. at 280.

Section 4.2 is equally troublesome in this regard. In effect it requires that the Commission approve in advance, without knowledge of the specifics, a transfer of APS's generation assets and non-generation "competitive services" assets to one or more corporate affiliates of APS or its parent, Pinnacle West. In the event the Commission might subsequently conclude that APS retained competitive services assets or functions that should have been transferred away from it in its role as a utility distribution company ("UDC"), it appears there is little that the Commission could do to rectify the situation and the resulting anti-competitive effect. This so because of the language of Section 7.1 of the Settlement Agreement, which provides as follows:

> "To the extent any provision of this Agreement is inconsistent with any existing or future Commission order, rule or regulation or is inconsistent with the Electric Competition Rules as now existing or as may be amended in the future, the provisions of this Agreement shall control and the approval of this Agreement by the Commission shall be deemed to constitute a Commission-approved variation or exemption to any conflicting provision of the Electric Competition Rules."
> [emphasis added]

Taken in conjunction with the above-quoted provisions of Section 6.1 and 6.2, and the holding in the U.S. West case, it would appear the Commission would be powerless at that

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juncture to meaningfully act. Clearly, such a circumstance would not be in the public interest, nor consistent with the Commission's objective of creating a competitive retail electric market.

Moreover, this not a hollow concern. Section 4.2 provides

> "The assets and services to be transferred <u>shall include</u> the items set forth on Exhibit C attached hereto." [emphasis added]

However, Exhibit C contains only generation related assets. No non-generation "competitive services" assets are identified, and APS witness Davis was vague during cross-examination by PG&E ES as to what types of non-generation "competitive services" assets and functions would in fact be transferred pursuant to Section 4.2. Thus, the Commission in effect is being asked to sign-off in advance on a transfer of assets yet to be identified which could substantially affect the ability of new entrants to compete in APS's service area.

Against this background, the true purpose of the above-quoted portions of Sections 6.1 and 6.2 is highly suspect. Moreover, none of the signatory Parties to the Settlement Agreement have offered any credible evidence as to why it is necessary that the Commission become a party as a consequence of its approval of the document. In PG&E ES's view, no legitimate reasons for such a requirement exist. Rather, it believes that the purpose of the language in question is to "handcuff" the Commission from undertaking any subsequent remedial or corrective measures otherwise within its power, in the event subsequent implementation of the Settlement Agreement should disclose that it is in fact anti-competitive in nature and/or effect. This is particularly egregious since the Commission is being requested to approve in advance or "sign-off" on several significant matters without prior knowledge as to the specifics of APS's intent or actions.

Indeed, with this Commission handcuffed by the APS settlement, there would seem to be little reason to continue with the development of the retail competition rules, for Section 7.1 provides that those rules would be inapplicable to APS to the extent they are not codified in the APS settlement. Surely this Commission cannot discharge its obligation to the public interest by approving a settlement that forever ties its hands against monitoring anti-competitive conduct and taking all appropriate actions to ensure the development of a robust competitive market.

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D. Conclusion:

As the foregoing discussion aptly demonstrates, regardless of what other modifications to the Settlement Agreement the Commission may consider, it must condition any approval it might ultimately issue upon the express condition that the above-quoted provisions of Sections 6.1, 6.2 and 7.1 be deleted from the final document[2]. In addition, it must expressly retain jurisdiction to address and correct any unintended anti-competitive circumstances and effects which might result from implementation of the Settlement Agreement. Otherwise, the Commission cannot rationally conclude that the Settlement Agreement is

> "...for the purpose of establishing terms and conditions for the introduction of competition in generation and other competitive services that are just, reasonable and <u>in the public interest</u>." [Settlement Agreement, page 1, first paragraph] [emphasis added]

II.

THE SETTLEMENT FAILS TO ALLOW A ROBUST COMPETITIVE RETAIL ELECTRIC MARKET TO DEVELOP

A. Introduction:

As previously noted, the signatory parties to the Settlement Agreement represent that have entered into the same

> "...for the purpose of establishing terms and conditions for the introduction of competition in generation and other competitive services that are just, reasonable and in the public interest." [page 1, first paragraph]

Elsewhere they state the provisions of the Settlement Agreement

> "...will provide customers with competitive choices for generation and certain other retail services." [page 1, third paragraph]

As a foundation to determining whether to approve the Settlement Agreement, the

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[2] Furthermore, in light of the content and effect of Section 7.1, the Commission should require detailed information from APS as to what generation and non-generation "competitive services" assets and functions it intends to transfer pursuant to Section 4.1 and 4.2, as well as a specific proposed interim Code of Conduct, before the Commission considers and renders a decision on the Settlement Agreement and the proposed Standard Offer and unbundled rates and tariffs.

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Commission must determine whether these representations are in fact accurate. In order to do so, the Commission should initially inquire as to what circumstances and attributes are necessary in order for a viable competitive retail electric market to exist. Then, it should examine the provisions of the Settlement Agreement and the accompanying Standard Offer Rates and unbundled rates to see if they are consistent with the promotion and realization of that objective. PG&E ES believes the Commission will determine that the Settlement Agreement does not accomplish these purposes, despite its representations to the contrary.

B. Prerequisites To A Competitive Retail Electric Market:

Experience to date in other jurisdictions transitioning to retail electric competition teaches that the market structure rules must adequately address and neutralize the incumbent utility's inherent advantages. In order to induce a customer of that utility to switch, a new entrant electric service provider ("ESP") must be able to offer energy at a lower price than the customer would otherwise pay to the incumbent utility. However, this price must also allow the new entrant an opportunity to recover all its costs of providing retail electric service, not just the wholesale cost of the commodity, and earn a profit. If the incumbent utility's standard offer (or default) energy price is set too low, then the ESP will not be able to price below the utliity's price, and meaningful retail competition cannot occur.

In creating a market structure to introduce and facilitate competition, there are three flaws or defects which the Commission should consciously seek to avoid. The first of these is an insufficient spread between the allowed retail energy credit and the wholesale market price of power. The second is an inadequate recognition of the ESP's market entry and customer acquisition costs. The third flaw occurs when the credit allowed for meter data processing and billing and collection costs fails to take into account all non-commodity costs of retail electric service and therefore is too low.

(1) Flaw No.1: Insufficient Spread Between Allowed Retail Energy Credit and Wholesale Market Price of Power.

In order to be adequate, and thus allow meaningful and ongoing competition, the retail energy credit must take into account all power procurement related costs, and all costs and values associated with retail electric service. These include at a minimum the following,: (i) market price of wholesale energy; (ii) additional value of shaping and load following; (iii) premiums associated with risk of serving retail load; (iv) competitive supplier

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delivery costs; (v) commercial costs, such as load forecasting and profiling, bad debts, office overhead and customer service; and (vi) a reasonable profit. Absent the design of a retail energy credit which provides an opportunity to fully recover these costs of doing business, a new entrant cannot stay the course and true competition cannot exist. If the incumbent utility continues to offer regulated retail service to its customers, as APS proposes, regulatory practice is to credit a switching customer bill with the cost of energy no longer procured from the utility. This credit must take into account all costs of retail electric service, not merely the wholesale cost of the electric commodity.

<u>(2) Flaw No. 2: Inadequate Recognition of New Entrant's Market Entry and Customer Acquisition Costs</u>

Central to an appreciation of this flaw must be a recognition that the incumbent utility is not confronted with these types of costs. At the onset of competition, it has 100% market share of the existing customer base. The utility incurs no ongoing customer acquisition or market entry costs to acquire these customers—it already has these customers because under the traditional regulatory practice, the utility was granted a monopoly franchise to serve these customers in exchange for subjecting itself to cost-of-service regulation. As long as the incumbent utility remains the default provider, it is the ESP who must induce retail customers to switch. In so doing, the ESP will necessarily incur significant costs in order to enter the UDC's market. Examples include expenditures associated with the certification process, negotiation of service arrangements with the UDC, and electronic interface systems. In addition, the ESP will incur customer acquisition costs in the form of advertising, marketing and sales expenses. In order to compete, it needs to be able to recover all of these expenses as well in its market price for electricity, plus a reasonable profit. If the allowed retail energy credit is only equal to or slightly above the wholesale market price of power, it will fail to adequately take into account the UDC's inherent advantages; and a viable competitive market in all likelihood will not develop.

<u>(3) Flaw No. 3: "MDBC" Credit Is Too Low</u>

The third type of flaw occurs when the credit allowed for meter data processing and billing and collections ("MDBC") costs attributable to customers leaving the UDC's system is too low. The typical practice, proposed by APS, is to credit these costs on an avoided cost basis, that is, the costs avoided by the utility in not providing the service. However, in a credit based regime, the costs of the MDBC function are typically buried in the distribution component of the incumbent utility's bundled retail supply rate. By crediting the switching customer's ESP only on an avoided cost basis for MDBC services no longer provided, the utility will nevertheless continue to recover the infrastructure costs (the difference between the avoided cost credit and the fully allocated costs of the MDBC function) in the distribution charge, which in turn is paid by all customers receiving distribution services, including switching customers. In this regard, it is important to note that use of the UDC's "avoided costs" as a credit design methodology does not adequately reflect the costs an ESP will incur in creating an infrastructure to provide such services.

(4) Corrective Measures To Neutralize Or Offset The Incumbent UDC's Inherent Advantages

Several corrective measures exist for neutralizing or offsetting the advantages inherent to the incumbent UDC. (As will be discussed in the following section, the APS settlement does not offer any corrective measure to offset APS's significant incumbent advantages.) The first of these is the design of an adequate retail energy or "shopping credit" which will provide the ESP with sufficient economic "headroom" or "operating room" to compete. Under the shopping credit concept the credit would consist of (i) an amount equal to the UDC's cost of energy not sold to the retail customer, and (ii) an "adder" designed to provide the ESP with a reasonable opportunity to sell energy at a delivered cost (including profit) at or below the total credit. This adder is a proxy for the non-commodity costs of retail energy services no longer provided by the UDC to direct access customers, and also recognizes that the UDC does not face market entry and customer acquisition costs.

The second corrective measure entails the use of a "bottoms-up" approach in the design of the UDC's rates for transmission and distribution service. The distribution component of the bundled retail supply rate typically contains the non-commodity costs of retail services (e.g., sales, advertising, various customer care costs such as metering, billing, and collection, retail load shaping and management). For example, as discussed above, the MDBC infrastructure costs (such as the computer systems) are buried in the distribution component. The direct access customer should not pay these costs since it is no longer receiving such retail services from the UDC. For this reason the distribution rate for a direct access customer must be lower than the distribution component of the UDC's bundled supply

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rate. The "bottoms up" approach ensures that the distribution rate for direct access customers does not contain any non-commodity costs of retail energy service.

The "avoided-cost" credit approach fails to take into account all these costs, resulting in an energy credit and a meter-bill-collect credit that are too low. This results in the direct access customer paying twice for the non-commodity costs of retail services, once to its competitive supplier and again to the UDC. The best way to avoid this impediment to competition is to develop a wires charge from scratch, ensuring that the direct access distribution rate includes only those costs absolutely necessary to deliver energy to direct access customers.

The final corrective measure, if one desires to eliminate completely the UDC's inherent advantage in having no market entry or customer acquisition costs, is to require that the UDC remove itself from the default provider role for some (e.g. industrial and large commercial) if not all classes of customers. However, adoption of this measure is not a prerequisite to the Commission's adoption and use of either of the first two corrective measures.

The Commission is uniquely positioned to adopt an approach that will allow it to avoid the market structure flaws discussed above through adoption and use of the aforesaid corrective measures. The Retail Electric Competition Rules have not been finalized as of this juncture. The Settlement Agreement and accompanying tariff and rate filings present a case of first impression for a planned opening of APS's heretofore exclusive electric service area. As the discussion set in Section III below indicates, this Commission should approve the Settlement Agreement only if it is modified to (i) avoid the types of market structure flaws discussed above, and (ii) address the additional problems therein identified.

C. <u>The Settlement Fails To Neutralize APS's Advantages:</u>

The Standard Offer and unbundled distribution rates to be approved by the Commission must reflect a full cost allocation away from APS of the "competitive services" infrastructure and functions to be transferred to its affiliate(s) pursuant to Sections 4.1 and 4.2 of the Settlement Agreement. Only in this manner can the Commission avoid the problem of Standard Offer and direct access customers subsidizing the competitive affiliate through APS's distribution rates. Stated, differently, the competitive affiliate should be

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required to bear the full cost of the competitive services infrastructure and functions which it acquires.

Absent such action, direct access customers switching to an ESP would continue to pay for the non-commodity retail service infrastructure costs, which are currently buried in the distribution rate, despite the fact they would no longer be receiving such service from APS[3]. Or, as is more likely, they would never switch because the ESP would be unable to fully recover its market entry and customer acquisition and care costs, as well as earn a profit, in an electric supply price which would be competitive with APS's affiliate, which was effectively being subsidized.

The specific problems with the Settlement Agreement's rate and credit components are well set forth in Mr. Oglesby's direct testimony and were not challenged on cross examination.

(1) Proposed Rate Reductions

The signatory parties to the Settlement Agreement have characterized the rate reductions provided for by Section 2.2 as a "benefit" resulting from the settlement process and the onset of competition. On its face, that would appear to be the case. However, the manner in which the rate reductions are proposed to be implemented would have an effect detrimental to retail electric competition.

More specifically, APS is proposing that the rate reductions be applied against the "contestable" (or commodity) component of the Standard Offer rate. Therefore, in order to induce a customer to switch, an ESP will have to price its commodity at a lower level than the APS commodity component which has been so reduced. It would be one matter if the ESP only had to obtain power supply on the wholesale market at a price equivalent to APS's Standard Offer commodity component as each scheduled rate reduction is effected. However, experience to date has shown that an ESP must be able to offer its commodity at a discount (e.g. 10%) below the UDC's commodity rate, in order to successfully induce customer switching. The likelihood of an ESP being able to obtain and price its power at a level 5%-10% lower than APS' reduced commodity component is extremely remote, as recognized even by APS's witness Landon. Mr. Landon testified that he was concerned that

[3] Conversely, with such cost allocation, the unbundled distribution rate for direct access customers would necessarily (and appropriately) be lower than the distribution component of the Standard Offer or bundled rate.

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APS had taken on significant risk with the 5% discount because APS may not be able to cover that discount in its power procurement costs. Certainly, if there is material risk that APS will not be able to obtain its power at a cost low enough to allow it recover those costs in its discounted standard offer rate, there must be serious question whether any ESP could do so. Even worse, the ESP must also recover all its non-commodity costs of retail electric service as well as its power procurement costs in its price, but must still offer a price significantly below the 5% discounted tariff.

However, this does not mean that customers should not receive the proffered rate reductions. Rather, it simply means they should be implemented in a manner that is competitively "neutral." This can be accomplished by the Commission's requiring that the scheduled reductions be taken off of APS's distribution rate, so that all customers, including direct access customers, receive the benefit and not just those on Standard Offer. Surely the Commission does not intend to confine the benefits of competition to Standard Offer customers, and in the process give APS and its competitive affiliate a "leg up" on new entrant ESP's.

(2) APS's Credits Are Inadequate

APS has failed to credit for the non-commodity costs of retail electric service. Its only proposed credits are for meter, meter reading and billing. Indeed, APS's proposed billing credit of a trivial $.30 underscores the deficiencies of the "avoided cost" approach to designing credits. APS witness Landon testifed that under principles of economic efficiency, credits should be at "avoided cost," that is, the costs avoided by APS, for example, by no longer performing billing and collection activities as a result of a customer switching to an ESP and leaving the APS system. Yet, the proposed $.30 credit is less than the cost of the first class postage stamp that would be required in order to mail that customer's bill! Moreover, to suggest that a postage stamp is the only "avoided cost" is disingenuous at best, and clearly not a discharge of APS's probative burden, implicitly conceded by Landon, to establish that the credit is in fact based on its avoided costs.

Importantly, Landon's economic efficiency argument ignores that the direct access customer will continue to pay for the underlying billing infrastructure in the distribution rate, but will receive no services from that infrastructure. The direct access customer instead will

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receive its billing as well as all other retail services from the ESP. The direct access customer, therefore, will pay for billing and other retail services twice -- once to its ESP, and the second to APS. This means that direct access customers will be subsidizing either APS's Standard Offer customers or its shareholders. This is an unacceptable, if not impossible, burden for competition to overcome.

Equally important is that the settlement also fails to provide any credit at all for other costs of retail electric service, such as risk management, shaping and management of retail load, load forecasting and profiling, non-billing customer care services, and office overheads. APS will no longer be providing these services, yet does not even offer to credit these services' avoided costs, much less their fully allocated costs, either in the energy credit or otherwise.

This is a very serious problem under APS's proposed rates, and one which its witness Landon failed to address in his analysis. It can be effectively addressed under the "bottoms-up" (or "wires-only") approach described in Section II above. In addition to addressing the related market structure flaws previously discussed, this methodology also provides that "economic efficiency" which witness Landon professed to seek; and, in a manner that avoids the need for continuing regulatory oversight of "avoided cost" credits.[4, 5]

PG&E ES strongly prefers from a policy perspective that APS be required to exit the retail supply market, including as a provider of last resort or default provider for large commercial and industrial customers. Alternatively, but less desirable, this Commission should at the very least properly set the energy credit to include the full costs of providing retail electric service, including all non-commodity costs, and require APS to develop a "bottoms-up" direct access distribution rate.

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[4] If, however, a credit based methodology were to be adopted, any under collection of the retail service revenues requirement caused by crediting the fully allocated costs of retail services could (and should) be deemed to be a recoverable stranded cost.

[5] If the Commission should conclude to utilize a credits-based approach, it must be sure the credits do not provide a competitive advantage to the incumbent UDC. APS's proposal does because it in effect requires an ESP or its customer to absorb APS's cost. For example, APS's proposed energy credit is based on a wholesale price signal, and fails to account for the full cost of the non-commodity retail service costs APS will avoid by not serving direct access customers. The same is true of APS's proposed billing credit, as more fully discussed below.

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III.

THE ASSET TRANSFER PROVISIONS OF THE SETTLEMENT ARE FATALLY FLAWED

As currently structured, the Settlement Agreement and Exhibit C ask the Commission to approve in advance a subsequent transfer by APS of (i) identified generation assets and (ii) non-generation "competitive services" assets yet to be identified. Moreover, the Commission is asked to do so without any evidence that the market value of such assets would be less than their book value, or indeed without any evidence at all as to the market value of those assets. This is truly the proverbial "pig-in-a-poke," and an insult to the intelligence of the Commission. It is impossible for the Commission to reach an informed decision as to whether such transfer(s) pursuant to Sections 4.1 and 4.2 would be in the public interest and in furtherance of creating a competitive market without having specific information as to the identity, extent and value of the non-generation "competitive services" assets to be transferred. In fact, the Commission is not even in a position to insure that APS would in fact be divesting itself of all of the non-generation "competitive assets" that it should. Much more detail is required than has been provided in order for the Commission to make an informed and legally defensible decision.

In addition, APS has offered no credible evidence to support the book value basis for generation assets contemplated by Section 4.1 Assuming arguendo that the market value of APS' nuclear generation assets is less than book at this time, that is no evidence that the market value of its non-nuclear generation assets is book or less. Rather, it is no evidence at all. APS should be required to obtain appraisals by Commission-approved appraisers as to the market value of those non-nuclear assets. The cost of such appraisals could be included in those stranded costs subject to the prospect of recovery, if not recovered in actual sales(s) of such units.

More specifically, while it may be true that the market value of the portfolio of non-nuclear and nuclear assets is less than the total depreciated book, the Commission has no way of knowing that based on the record. At the very least, the assets should be appraised by independent appraisers to determine their fair market value. Does APS assume Palo Verde has no market value? If not, what is its assumption? If so, that is clearly an invalid assumption, since a market for nuclear plants is developing.[6] In addition, APS witness Davis' statement in his rebuttal testimony that the NRC has never approved the transfer of an opertaor's license to a non-affiliated entity is technically true, but disengenuous. There are at least two pending sales of nukes to non-affiliates—license transfers have not been refused; they haven't been acted on yet.

In addition, APS' approach is a disservice to its rate payers. There is simply no doubt that ratepayers would be better off if APS were to separate the generation assets into two separate tranches, non-nuclear and nuclear. The non-nuclear should either be auctioned or appraised separately because they will have a higher value than if bundled with Palo Verde. There are far fewer potential purchasers of a portfolio consisting of both nuclear and non-nuclear than there are purchasers of non-nuclear assets only. Stated simply, this is one of those rare cases where the whole (the aggregate value of nuclear and non-nuclear) is worth less than the sum of its parts (the value of non-nuclear to one set of purchasers plus the value of nuclear to another set of purchasers).

APS does not deny that the non-nuclear assets' market value is higher than book; it is the aggregate of Palo Verde and the non-nuclear that APS contends is below book, meaning that Palo Verde is the anchor. What, then, is to prevent the APS Generating Affiliate, once it acquires all the generation assets, from promptly breaking up the bundle and selling off the pieces; that is, selling the non-nuclear assets and either keeping Palo Verde or selling it separately? That would be the economically rational thing to do.

If the generating affiliate were to do that, there would be a tremendous wealth transfer from ratepayers to shareholders, and APS would reap a windfall which could be used to fund other competitive activities to the disadvantage of other competitors. This highlights why it is inappropriate to permit the book value transfer of the assets to the generating affiliate. Palo Verde and the non-nuclear units are simply not joined at the hip -- indeed, it is illogical to lump them together since no other acquirer would do so. At the very least, the Commission should condition the asset transfer on APS's agreement that it will not allow

[6] In this regard, in his rebuttal testimony, APS witness Davis says that transferring the non-nuclear gen assets with APS retaining PV is "too horrible to imagine." Yet several utilities are doing just that, including Pacific Gas and Electric Company, Southern California Edison (one of the co-owners of PV), Commonwealth Edison, New England Electric System, as PG&E's witness Oglesby testified. APS has offered no evidence to support a claim of "inability to sell," and probably hasn't even tried.

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the resale of any of the assets for a substantial number of years (pick a number—at least 5).

Finally, the Commission should retain the right to review and approve or reject any proposed financing arrangements associated with future transfers of "competitive services" assets from APS to one or more affiliates. The language in Sections 4.1 and 4.2 provides in effect that the Commission will have approved in advance such financing arrangements as APS may hereafter negotiate with its affiliate(s). When questioned during cross-examination by PG&E ES as to the structure and nature of such financing arrangements, APS witness Davis could offer no specific information as to the structure, security or cost of the same. Under these circumstances, it is impossible for the Commission to make an informed and legally defensible decision as to whether such transfers would be in the public interest.[7] Yet that is in effect what the Settlement Agreement requires it to do!

IV.

OTHER ANTI-COMPETITIVE PROVISIONS OF THE SETTLEMENT

A. Proposed One--Year Advance Notice Requirement:

Section 2.3 provides that

> "Customers greater than 3 MW who chose a direct access supplier must give APS one year's advance notice before being eligible to return to Standard Offer service." [emphasis added]

However, APS has not offered any credible evidence to support the imposition of such an "eligibility" requirement.

In reality, no such basis exists. The customers affected by this provision are customers APS would have already constructed facilities to serve, as indicated by the word "return." Hence, there is no operational barrier to an immediate return to APS's system if such facilities still exist. If they have been removed or the capacity of same has been committed to another customer in whole or in part, the cost of and timetable for installing the necessary facilities can be provided to the customer in question as a cost to it of returning to the APS system. Given such information, the customer can then make an informed decision as to what to do.

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[7] In this regard, it should be noted these assets are presumably "used and useful" as of the time of transfer by APS. Hence, the Commission clearly has an interest in assuring that APS and its ratepayers interests are adequately secured under whatever means of financing is ultimately selected. and that APS's ability to thereafter perform its regulated UDC role will not be jeperadized by the proposed transfer(s).

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Similarly, the cost to APS of acquiring electric supply to serve the returning customer also does not require one-year's advance notice. APS can simply flow any increased power supply costs directly to the customer in question as a condition to its return. In both this instance, and the situation discussed in the preceding section, the principle of cost-causation recovery responsibility would be adhered to, as should be the case.

The real purpose underlying the proposed "eligibility" requirement is an attempt on APS's part to create a deterrent to load switching by large industrial, institutional and commercial customers. There is no factual or regulatory policy basis to support the imposition of such a requirement, and the Commission should reject it.

B. <u>The Proposed 3-Year Transfer Period:</u>

Section 4.1 provides APS with

> "... a two-year extension of time until December 31, 2002 to accomplish such separation [of its competitive services assets]

In reality, APS is seeking three full years (plus the remainder of 1999) in which to complete such separation. However, it has offered no credible evidence to support the proposed extension.

If the goal of introducing retail electric competition into APS's service area is to be seriously pursued, APS should be confined to performing the role of a non-competitive, regulated UDC. In that regard, it should be required to transfer its generation and non-generation "competitive services" assets and functions as soon as possible, and the Commission should carefully monitor its activities during this period to insure APS does not confuse its role or violate the Retail Electric Competition rules to be adopted later this year. Furthermore, under no circumstances should the automatic two-year extension contemplated by the Settlement Agreement be approved. Rather, the period currently allowed for transfer activities should remain in place. If APS finds, with experience, it in fact needs an extension as it moves through the year 2000, it can petition for one at that time.

CONCLUSION

It is readily apparent from the foregoing discussion that the Settlement Agreement and proposed Standard Offer and unbundled rates and tariffs should not be approved without modifications of the nature discussed above. The Commission has a process well under way for bringing retail electric competition to the State of Arizona. The Settlement Agreement, and the approval of APS's proposed Standard Offer and unbundled rates which it mandates, would accelerate

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that process as to APS's service area. However, it would do so in a manner substantially, and perhaps irretrievably, to the detriment of new entrant ESP's and their ability to offer meaningful and ongoing competition to APS and its competitive affiliate. Stated differently, blind acceptance by the Commission of what the signatory parties have proposed (and contractually require) would be a classic illustration of "penny-wise and pound-foolish." In addition, such action might also be legally indefensible.

DATED THIS 4TH day of August, 1999.

Respectfully submitted,

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These are from the Az State Bar Book & Motions to Intervene.

Hopefully the bar book is correct.