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IN THE MATTER OF 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 FILING OF ARIZONA
PUBLIC SERVICE COMPANY OF
UNBUNDLED TARIFFS PURSUANT TO A.A.C.
R14-2-1601 ET. SEQ.

DOCKET NO. E-010345A-97-0773

IN THE MATTER OF COMPETITION IN THE
PROVISION OF ELECTRIC SERVICES
THROUGHOUT THE STATE OF ARIZONA

DOCKET NO. RE-00000C-94-0165

STAFF'S BRIEF

I. INTRODUCTION

On May 14, 1999, Arizona Public Service Company ("APS" or "Company") executed a Settlement Agreement ("Agreement") with the Arizona Residential Utility Consumer Office, the Arizona Community Action Association, and a group calling itself Arizonans for Electric Choice and Competition ("AECC"). Enron Corporation and/or subsidiaries of Enron Corporation were at one time members of AECC, but did not execute the Agreement, and withdrew from AECC. The Agreement represents an attempt to resolve a number of issues relating to introducing competition in the electric utility industry, consistent with the efforts being pursued by the Commission and Staff over the last several years.

Pursuant to Procedural Order, the signatories provided testimony in support of the Agreement, and Staff, as well as several intervenors, submitted comments and/or testimony relating to the Agreement. Following the evidentiary hearing, this brief is submitted, describing Staff's support of modification and approval of the Agreement.

1 Staff's testimony supports approval of the Agreement, with certain modifications,
2 based on meeting the Commission's objectives to introduce competition quickly, while ensuring the
3 development of a true competitive market and providing benefits to all customers during the
4 transition to competition. With one exception, other parties' comments and testimony proposed
5 approval, modification or rejection of the Agreement based on similar considerations. The exception
6 is the Arizona Consumers Council ("Council"). The Council did not provide an analysis of the
7 Agreement's relative merits in the context of restructuring the electric utility industry. Instead, the
8 Council provided objections to the Agreement that could only be characterized as legal objections.
9 The Council claimed that the Commission may not lawfully approve the Agreement as proposed,
10 rather than providing any specific plan for restructuring the industry.

11 This brief contains two sections. First is Staff's response to the Council's legal
12 arguments. Staff believes that the Commission may lawfully approve the Agreement, particularly
13 if modified as we recommend.

14 The other section discusses Staff's specific recommendations. Staff believes that the
15 public interest will be served by approving the Agreement, following modifications. Staff's
16 proposed changes to the Agreement will ensure the development of a true competitive electricity
17 market in Arizona, while continuing to provide benefits to all customers during the transition period.

18 **II. LEGAL ARGUMENT**

19 The Council's Comments and Opening Statement provide its objections to the
20 legality of Commission approval. Those legal arguments fall into three categories. First, the
21 Council asserts that the Commission must conduct a full rate proceeding. The reasons are: the
22 Commission will not have evidence to support a finding that the resultant rates are just and
23 reasonable; rate payers will be overcharged due to rate base reductions caused by the transfer of
24 competitive assets, and; the Commission may not lawfully establish an adjustment clause outside
25 a general rate case.

26 The second legal argument is that the Commission may not lawfully approve the
27 provisions regarding possible rate changes before the required full rate proceeding. The Council
28

1 asserts that the Commission may not approve Section 2.8, which it claims would foreclose
2 Commission initiated rate reductions, violating A.R.S. § 40-246.

3 Finally, the Council asserts that the Commission may not lawfully approve the
4 Agreement, because this Commission may not bind future Commissions. The argument is made in
5 two contexts. First is the general claim that the Commission may not bind future Commissions from
6 exercising the constitutional responsibility to set rates. Secondly, the Council claims that the
7 Commission may not bind a future Commission to implement an adjustment clause.

8 Staff's legal analysis reaches differing conclusions from those of the Council. Staff
9 believes that the Commission may lawfully approve the Agreement. We also provide suggestions
10 to strengthen the legality of such an approval.

11 **A. The Commission May Approve the Agreement Without a Rate Case.**

12 The most pervasive legal objection from the Council is that the Commission may not
13 approve the Agreement without a rate case. This argument is found at page 2 of the Comments and,
14 with some ambiguity, in counsel's opening statement. For example, several times counsel used
15 phrases like "absence of financial information". Counsel offered the view that he was not suggesting
16 a full rate proceeding (Tr. at 69). But he did not tell us what he was suggesting, only making a vague
17 accusation that approval in this proceeding would be illegal.

18 If the Council's brief develops the vague suggestion that the alleged illegality is
19 something other than failure to hold a rate case, Staff will request the opportunity to respond to those
20 new arguments. In the meantime, Staff concludes that the Commission may lawfully approve this
21 Agreement in this proceeding.

- 22 1. The Commission has adequate evidence that the rates approved herein are just
23 and reasonable.

24 The first Council argument that a rate case is necessary is that there will be
25 inadequate evidence in this record for the Commission to conclude that it is approving just and
26 reasonable rates (Comments at 2; Tr. at 65-66). The inference is that the Commission must conduct
27 a rate case, find the fair value of APS' property and use that information to develop rates in this case
28 before determining that the rates are just and reasonable. If the Council's logic were followed, a full

1 rate case would be necessary every time any rate changed, including: adjustment clauses, interim
2 rates, step rate increases and rate changes pursuant to an approved formula.

3 The Council has the rate making process backwards. The Commission has
4 determined just and reasonable rates for APS, in its last rate case. The finding is valid until it is
5 determined that they are no longer just and reasonable. This is the genesis of the retroactive rate
6 making doctrine. Once the Commission has determined just and reasonable rates, those rates must
7 be charged until changed in a rate proceeding, See Pueblo del Sol Water Company v. Arizona
8 Corporation Commission, 160 Ariz. 285, 287, 772 P.2d 1138, 1140 (App. 1988). If the Council
9 believes current rates are not just and reasonable, mechanisms exist to challenge them. There is
10 ample evidence that this case is not an attempt to change existing rates, only to introduce the new
11 service of direct access. (Tr. at 464-65). Mr. Propper's testimony is that the direct access rates in
12 this proceeding were designed to provide revenue flows that would replicate those from APS'
13 existing rates (Tr. at 465). APS has voluntarily agreed to a series of reductions to those rates, but
14 there is no reason to believe that the reductions render the rates unjust or unreasonable. The Council
15 provided no evidence to dispute Mr. Propper. The Commission has routinely, and lawfully,
16 approved rates for new services outside a rate case. The inquiry is to determine whether revenue
17 from a new service will affect the utility's rate of return. In this case, rates were designed to
18 replicate the revenue flows from existing, approved rates, consistent with the requirements of Scates
19 v. Arizona Corporation Commission, 118 Ariz. 531, 578 P.2d 612 (App. 1978).

20 In any event, this record contains evidence from which the Commission may find fair
21 value and a fair rate of return. Mr. Propper's testimony supports a fair value rate base of
22 \$5,195,675,000 and a fair rate of return of 6.63% (Direct Testimony of Alan Propper, Ex. APS-2 at
23 6). The calculations are based on 1998 and are uncontroverted. While Staff does not believe that
24 the Commission is required to find fair value in this case, we encourage the Commission to include
25 such a finding in the order.

26 Finally, the Council claims that no financial information exists to support the
27 Agreement or the rate reductions flowing from the Agreement. This is simply untrue. The rates and
28 reductions proposed in the Agreement are directly related to complete financial review. In Decision

1 No. 59601, the Commission established permanent rates for APS. That Decision is final and not
2 appealable. The financial information and formula for rate reductions contained in Exhibit AP-3,
3 appended to Exhibit APS-2 (Testimony of Alan Propper), provides current financial information
4 supporting current rates. The Council provided no contrary financial information. The Council
5 should not be permitted to mount a collateral attack on Decision No. 59601 in this docket.

6 2. Ratepayers will not be double charged as a result of the transfer of assets
7 under the Agreement.

8 The Council's legal objection to stranded cost recovery is a concern over double
9 recovery from ratepayers. Despite noting that the Agreement does not change rate base, since this
10 is not a rate case, the Council claims, since current rates are designed to recover all costs, including
11 potentially stranded costs, once assets are transferred to an affiliate, ratepayers will be paying both
12 a return on the assets and a separate stranded cost charge.

13 While this concern is stated as a legal objection, it is mostly a misunderstanding of
14 the facts of the transaction. Mr. Davis explained why no double recovery will occur (Tr. at 1108-
15 1110). Current rates recover all of APS' costs, including those which may become stranded. After
16 restructuring, Standard Offer customers will continue to pay existing rates, which include an
17 allocation of potentially stranded costs. Direct access customers' rates will include a Competitive
18 Transition Charge ("CTC"), to provide an allocable payment for their share of stranded costs. Thus,
19 Direct Access customers' rates will provide the same recovery of costs, in total, as Standard Offer
20 rates. The lower amount paid by Direct Access customers results from costs avoided as a result of
21 the transferred assets. As Mr. Davis explained, the assets will be transferred at book value, but APS'
22 recovery of that book value will be comprised of payments (or debt assumption) from the affiliate,
23 plus collection of CTC amounts (Tr. at 1046-1053).

24 There is a narrow, regulatory issue raised by the timing of the transfer of assets
25 compared to the rate case. The transfer of assets will result in a change to rate base, as well as other
26 ratemaking elements, when it actually occurs. A rate case is appropriate to determine the effect of
27 those changes. The Agreement addresses this situation. The transfer will occur on December 31,
28 2002. A rate case must be filed by June 30, 2003. Since Arizona is a historical test year jurisdiction,

1 a rate case test year ending December 31, 2002 is reasonable. The Commission will have authority
2 to remedy any problems created by the timing issue during consideration of the adjustment
3 mechanism. To provide assurance of no over recovery, the order approving this Agreement should
4 declare APS' rates interim and subject to refund as of the date of the asset transfer, pending
5 resolution of the rate case, consistent with Pueblo del Sol, 160 Ariz. at 287, 772 P.2d at 1140.

6 3. The Commission may lawfully establish an adjustment clause as provided in
7 the Agreement

8 The Council asserts that the Commission may not establish an adjustment mechanism
9 outside a rate case. The Council is wrong for at least two reasons. First, the Agreement does not
10 call for establishment of an adjustment mechanism outside a rate case. The timing is consistent with
11 the mechanism being considered within the rate case. Under Section 2.6 of the Agreement,
12 adjustment clause factors are required by June 30, 2003, with a projected effective date of July 1,
13 2004. Those dates allow considering the adjustment clause in the rate case, which will also be filed
14 on June 30, 2003, with an effective date of rates on July 1, 2004.

15 The other reason the Council is wrong is that there is no proscription of approval of
16 an adjustment mechanism outside a rate case. Scates, supra, discusses adjustment clauses as an
17 exception to the requirement that rate changes occur in a rate case. According to Scates, adjustment
18 clauses are permissible because, despite the fact that they allow increased revenue, they should not
19 affect net income due to increased expenses tracking the increased revenue. 118 Ariz. at 535, 578
20 P.2d at 616. The Scates court notes that adjustment clauses are usually adopted during a general rate
21 case, but does not require it. Rather, Scates speaks to the requirement that the Commission consider
22 the effect of a rate change on a utility's rate of return as a prerequisite to permitting a rate increase,
23 118 Ariz. at 537, 578 P.2d at 618. There is no reason to believe that a full rate case is required
24 before the Commission may implement an adjustment clause. Scates simply holds that the
25 Commission must consider the effect of rate changes on rate base and rate of return.

26 ...
27 ...
28 ...

1 **B. The Commission May Lawfully Approve the Agreement, Even if Rate Increases**
2 **May Occur but Decreases are Foreclosed.**

3 The Council objects to Section 2.8 of the Agreement. In its Comments, at page 4,
4 the Council asserts that the Agreement allows APS to seek changes in rates, while foreclosing rate
5 changes from Commission initiative. The Council claims that the provision is illegal since it would
6 bar the Commission from considering a petition pursuant to A.R.S. § 40-246.

7 Staff believes that the Commission may lawfully approve the Agreement. While
8 Section 2.8 may act to prevent the Commission from considering petitions under A.R.S. § 40-246,
9 the statute's constitutionality is doubtful. The Arizona Constitution gives the Commission full
10 power over utility rate setting. Under Arizona case law, the legislature may not interfere with the
11 Commission's exercise of that authority. To the extent that the statute impairs the Commission's
12 authority over rates, it is probably unconstitutional.

13 Nevertheless, Staff is sensitive to the concerns raised by the Council. It would seem
14 inappropriate to approve an Agreement allowing only the utility to seek rate changes due to
15 unforeseen circumstances. Staff recommends that, as a condition to approval of the Agreement,
16 Section 2.8 be amended to provide that the Commission or its Staff may initiate rate changes under
17 conditions paralleling those provided for the utility. Circumstances would at least include
18 unforeseen revenue increases and petitions submitted pursuant to A.R.S. § 40-246.

19 **C. The Commission May Lawfully Approve the Agreement, Even if it May Bind**
20 **Future Commissions.**

21 The Council questions whether the Commission may lawfully bind future Commissions in
22 two places in its Comments. At page 4, the Council asserts that the Commission cannot bind a
23 future Commission to establish an adjustment clause. In addition, page 5 of the Council's
24 Comments claims that Section 3.4^{1/} of the Agreement is illegal, asserting that this Commission is
25 "...completely without authority to prevent future Commissions from appropriately exercising their
26 constitutional responsibilities."
27 ...
28

1 The Council is simply wrong. The Commission can take actions that bind future
2 Commissions. It is a routine matter. The Commission has long approved settlements that include
3 rate moratoriums, including while the Council's attorney represented the Commission. In approving
4 rate moratoriums, the Commission weighs the benefits of current actions against the risks associated
5 with limiting exercise of its authority in the future. There is nothing different about this Agreement.

6 In fact, the approval of any settlement is likely to bind future Commissions to some
7 extent, whether or not the current Commission seeks to do so. In US West v. Arizona Corporation
8 Commission, 185 Ariz. 277, 915 P.2d 1232 (App. 1996), the Arizona Court of Appeals considered
9 the manner in which a subsequent Commission sought to apply the terms of a settlement entered into
10 nearly a decade earlier. The court applied contract law principles and found the Commission bound
11 by the terms of the settlement, as construed by the court.

12 It is clear that the Commission has the power to bind future Commissions in some
13 regards. It is also clear that there are ways in which the current Commission may not bind other
14 Commissions. It is unlikely that a current Commission could establish rules of general applicability
15 or general regulatory policies which would be immune from change by a future Commission.

16 The Commission should be aware of the binding effect of approving the Agreement,
17 and wary of the possibility of binding future Commissions to a greater extent than necessary. For
18 example, while the Commission may find it desirable to authorize future consideration of an
19 adjustment clause, it is unlikely that sufficient information exists from which to closely define the
20 parameters of such an adjustment clause.

21 The Commission should also be aware that approval of the Agreement may create
22 certain contractual rights which might be enforceable against it in the future. Neither the
23 Commission nor its Staff were active parties in negotiating this Agreement. There is no reason why
24 the Commission should make itself a party to an Agreement that it did not negotiate, as contemplated
25 by Sections 3.5 and 6.1. There is certainly no reason why the Commission should approve Section
26 7.1 of the Agreement, which would cause this Agreement to supercede any future Commission order,
27 rule or regulation. The Commission should condition approval of the Agreement on a reservation

28 1 Reference to Section 3.4 was probably intended to refer to Section 3.5 of the Agreement, which
actually contains language of the sort referenced by the Council. Staff's comments are directed at Section 3.5

1 of regulatory authority, except as necessary to implement the Agreement. The Commission should
2 specifically find that it does not become a party to the Agreement and that approval is a regulatory
3 order, not the creation of a contract.

4 **III. STAFF'S PROPOSED MODIFICATIONS**

5 Staff's policy witness, Ray Williamson, described Staff's review of the Agreement.
6 There are two objectives forming the core of the Commission's efforts at introducing competition
7 into the electric utility industry in Arizona. The objectives require balancing the immediate benefits
8 of known rate reductions against the impact of the Agreement upon the development of a truly
9 competitive market. Staff concluded that the Agreement requires modifications to facilitate the
10 development of a competitive market. Staff's proposed modifications to the Agreement are
11 primarily changes to the proposed unbundled tariffs. This is intended to allow a competitive market
12 to develop while preserving the balancing of interests at the heart of the Agreement. While Staff
13 does not endorse the financial underpinnings of the Agreement, our approach has been to work
14 within those parameters to develop recommended changes which will maximize benefits to all. This
15 course of action is in the public interest and the Commission should require modifications as
16 suggested herein as a condition to approval of the Agreement. Staff does propose one modification
17 that will clarify the procedures by which generation will be acquired to provide Standard Offer
18 service. As a final matter, Staff proposes clarifications that will allow the restructuring of APS to
19 be coordinated with that of other Affected Utilities. Specifically, Staff recommends delaying
20 approval of certain requested waivers until they can be addressed by the Commission on an industry
21 wide basis.

22 **A. Staff's Proposed Modifications To The Unbundled Tariffs**

23 Staff's proposed modifications to the unbundled tariffs encompass three concepts.
24 First, Staff proposes that tariffs be modified so that the reduction in rates that customers receive for
25 not buying generation, called the market generation credit ("MGC") or the "shopping credit", is
26 made explicit to the customer and comparable between standard offer and direct access tariffs.
27 Secondly, Staff proposes that the MGC amounts be increased, to permit a competitive market to
28

1 develop. Finally, Staff proposes modifying direct access tariffs to increase the metering and billing
2 credits to permit the development of a competitive market.

- 3 1. The Commission should require explicit MGCs, and comparability
4 between standard offer and direct access tariffs

5 To have access to the market, customers must be able to determine their MGC. The
6 MGC represents the amount a customer will save off standard offer by purchasing in the competitive
7 market. Only if the customer knows how much will be saved, can he determine whether a
8 competitor's price is lower than the standard offer rates. The Agreement's unbundled rates fail to
9 provide this information to the customer. As Staff witness Lee Smith points out in her direct
10 testimony, the tariffs do not inform customers of the MGC or transmission cost amounts included
11 in standard offer rates. Customers will know bundled tariff rates for standard offer and unbundled
12 rates for direct access service. The customers must compute the differences, which will vary for
13 each customer.

14 The Company's solution is to provide a second page to the customer's bill,
15 represented by Exhibit AP-1R, attached to Exhibit APS-11, the Rebuttal Testimony of Alan Propper.

16 There are several problems with the proposed solution. First, as Mr. Propper admitted, it is not
17 mandatory (Tr. at 1185-1186). The Commission should at least make it mandatory. More important
18 is the problem that the second page of the bill would only provide historical information, and only
19 for a single month. To determine what amounts are available to shop for alternatives to standard
20 offer service, the customer would have to make assumptions and projections of anticipated usage.

21 The customer would then have to make extensive calculations to reach a usable result.

22 The Commission should require that rates be unbundled into identifiable components,
23 so that a customer can determine the savings which could be obtained by converting to direct access
24 service on a per unit basis.

25 The problem is exacerbated by the fact that the standard offer and direct access tariffs
26 are not comparable. APS is unconcerned about the lack of clear price signals because the direct
27 access rates were "derived from" its current rates. This derivation is helpful to ensure that the rates
28 may be lawfully approved in this docket (See, Section II.A.1, supra). However, the lack of

1 comparability prevents customers from choosing between standard offer service and direct access
2 service, with competitive generation.

3 The example discussed at Tr. pages 1187-1191 illustrates the problem. The rate
4 comparison was from Page 2 of Exhibit AP-1R, attached to Exhibit APS-11, Rebuttal Testimony
5 of Alan Propper. The Exhibit shows a comparison of direct access service with standard offer
6 service for a hypothetical Rate E-32 customer. The Exhibit purports to develop an MGC, which the
7 customer could use to determine a comparison between competitive service and standard offer
8 service. The problem is in the manner in which the direct access rates were unbundled and the way
9 the Competitive Transition Charge ("CTC") is applied to the direct access tariffs. The demand
10 component of this hypothetical bill would have been \$175.75 on standard offer, but had the customer
11 chosen direct access, the same usage pattern would have a demand component of the direct access
12 bill of about \$315 (Tr. at 1190).

13 The point of this exercise is to show the problems of information content and
14 comparability that are caused by the tariffs proposed. A customer must make calculations and
15 projections relating to future usage, including load factor assumptions, to determine a possible MGC.
16 The Commission should require unbundled rates with an explicit MGC and comparable
17 components, stated on a per unit basis and separately for summer and winter.

18 2. MGCs should be increased.

19 Staff's review demonstrates that the proposed MGC amounts are too low. "In order
20 to create a competitive market, the market generation credits, particularly for the class most likely
21 to shop, the Extra-Large General Service class, must be increased." (Direct Testimony of Lee Smith,
22 Ex. S-2 at 14). The Company accuses Ms. Smith of advocating a "Pennsylvania model", wherein
23 shopping credits are set deliberately and significantly higher than what the market price of
24 generation is expected to be. The Staff's goal, in contrast, is to set the market generation credit at
25 "our best estimate of the retail market price." (Tr. at 959).

26 Ms. Smith's conclusion that the MGC is low is based on estimating a retail market
27 price that begins with the spot wholesale prices for day-ahead power traded at Palo Verde in the last
28 year. These must be adjusted for line losses, and both ancillary service and transmission cost must

1 be added, since APS is not providing these services directly for direct access customers. There is
2 almost no dispute about these adjustments. However, the retail price of electricity must also be
3 higher to reflect costs beyond the raw costs of generating power. To supply retail load requires
4 additional costs associated with balancing demand and supply since customers load shapes are not
5 completely predictable, and dealing with this variability costs money. Mr. Davis in Rebuttal
6 Testimony described the Company's "energy traders"; these are costs required to provide power to
7 customers that are not reflected in the wholesale spot price. Since the cost of energy traders is
8 booked as embedded generation costs, the Company will recover them as stranded costs while other
9 suppliers will have to recover them through market sales.

10 The Company and Mr. Higgins have both cited "shopping credits" for particular
11 customers or groups of customers that they claim demonstrate that the MGC is adequate. None of
12 these "analyses" compare apples to apples. The Company only calculated the shopping credit for
13 a select group of commercial customers. In addition, the Company compares shopping credit to
14 wholesale price, which is not correct. Comparing a select group of customers' shopping credits to
15 wholesale prices calculated on a total class basis does not provide a valid analysis.

16 Mr. Higgins also compared an estimate of a MGC for a particular customer to a
17 wholesale price; however, he calculated a wholesale price that would apply to a flat load, while the
18 customer that he used as an example had a relatively low load factor. His credit is not comparable
19 to the wholesale price that he used.

20 Ms. Smith calculated market generation credits by computing the full revenues that
21 would be paid by the entire class under the bundled tariff and subtracting the full revenues that
22 would be paid by the class under the direct access tariff. Neither the Company nor any other party
23 disputed this calculation, which represents the average MGC for the entire class.

24 Staff has even gone so far as to propose that the increased MGCs be permitted
25 without impacting the Agreement's proposed stranded cost recovery amount of \$350 million. Staff
26 proposes that the increased MGCs be offset by reducing CTCs. Ms. Smith suggested that the
27 amount of stranded costs not collected, if any, could be deferred and collection allowed after 2004.
28 Staff's intent, as clarified in cross examination of Ms. Smith, is to allow full recovery of the \$350

1 million, unless actual wholesale market prices are higher than the stranded cost calculation. While
2 APS expressed concerns about certainty of recovery, Staff believes that it's approach of allowing
3 higher MGCs while permitting recovery of the CTC after 2004 is the appropriate mechanism to
4 provide this assurance. It is the best way to ensure recovery of the agreed stranded cost amounts,
5 while not sacrificing the development of a competitive market.

6 It should be noted, in passing, that Staff does not support the notion that the stranded
7 cost calculations in the Settlement represent the appropriate stranded costs for recovery outside the
8 context of a Settlement. In particular, Staff does not agree with the calculation of \$533 million in
9 the Agreement. Ms. Smith testified that stranded costs, based on APS' own values, calculated
10 through 2026, would be \$456 million.(Tr. at 966). Staff does not propose to modify the Agreement
11 with respect to stranded cost amounts. However, it is clear that there is room for debate over the
12 reasonableness of the stranded cost calculations. Staff's proposed modification to increase MGCs,
13 while potentially extending the period for CTC collection, should be considered in the context of the
14 lack of certainty surrounding all stranded cost calculations.

15 3. Metering and Billing Credits should be increased

16 It is undisputed that the metering and billing credits employed by the Agreement are
17 based on decremental cost calculated assuming a very small migration of customers. (Tr. at 965).
18 It is unlikely that a competitive provider could provide metering and billing services without
19 charging substantially more than the allowed credits.

20 This situation creates two undesirable outcomes. First, the unreasonably low billing
21 credits make it unlikely that a competitive market can develop for metering and billing, despite the
22 Commission having determined these to be competitive services. Secondly, since customers taking
23 competitive generation will require metering and billing service, the unreasonably low credits will
24 act to reduce the margin that is available to consider as a "shopping credit". The result is that the
25 low metering and billing credits will also act to deter customers from seeking competitive generation
26 service at all.

27 APS argued that embedded metering and billing credits would cause it to lose revenues
28 because its costs would only go down by the very small decremental amounts calculated. Ms. Smith

1 testified that the Company would not lose significant income if it used embedded credits, because
2 it would have the ability to use freed up resources to serve new customers. As larger numbers of
3 customers choose alternative suppliers, it could reduce expenses that it has treated as fixed. Finally,
4 the Company could, and probably should, transfer metering and billing resources to a competitive
5 affiliate.

6 Staff has proposed credits based on the embedded cost of providing these services.
7 To the extent the Commission wishes to create a true competitive market, approval of the
8 Agreement should be conditioned on adoption of Staff's proposed metering and billing credits.

9 **B. Generation for Standard Offer Service Should be Acquired by Competitive**
10 **Solicitation**

11 After the Company divests its generation assets to an affiliate, APS will still need to
12 acquire generation service to meet the needs of Standard Offer customers. The acquisition process
13 should ensure that APS, the distribution company, does not favor its generation affiliate and that
14 Standard Offer customers have access to competitively priced power. The only place that this issue
15 is addressed in the Agreement is at Section 4.4. This section does not adequately describe the
16 acquisition of power. Mr. Davis indicated that he recognizes that the distribution company will be
17 required to engage in a competitive process to acquire generation (Tr. at 353-54).

18 Staff believes that the Commission should dictate a requirement of competitive
19 solicitation as a condition of approving this Agreement. Staff is particularly concerned because APS
20 appears to believe that there exists a possibility that previously acquired purchase power contracts
21 or generation exchange agreements might somehow be deemed competitively solicited (Tr. at 1118-
22 19).

23 Staff witness Lee Smith provided specific language which should be incorporated to
24 ensure that Standard Offer customers receive the benefit of competitively acquired generation. She
25 suggested the language similar to the following be incorporated into the Agreement: "The Company
26 will hold a competitive solicitation for standard offer power and if its EWG wins a part of this
27 solicitation, it may purchase standard offer power from its EWG at the bid price" (Tr. at 963). In
28 addition, the Commission should direct that the solicitation should seek multiple providers of power

1 to meet the Standard Offer load, so as to minimize the potential that an affiliate would be the only
2 entity able to meet the solicitation.

3 Staff's proposals are intended to ensure that Standard Offer customers receive the
4 benefit of the competitive market in the cost of generation supply they will be required to absorb.

5 The distribution company should not be permitted to purchase power directly on the spot market
6 or continue to directly accept power from existing power exchange agreements, which should be
7 transferred to the generation affiliate. Otherwise, the risk exists that Standard Offer customers will
8 continue to pay monopoly, not competitive, prices for generation. There should also be no incentive
9 for the distribution company to favor its affiliate in acquiring generation to supply Standard Offer
10 service.

11 **C. Staff's Proposed Treatment of Requested Commission Approvals and Waivers**

12 Staff witness Ray Williamson testified regarding Staff's proposed treatment of
13 approvals and waivers requested by the Agreement. Mr. Williamson suggested that the requested
14 approvals and waivers neither be granted nor explicitly denied at this time. Mr. Williamson
15 suggested that the Commission reserve its judgment on the requested waivers until the Commission
16 is able to conduct an industry-wide review, rather than granting a blanket exemption for APS and
17 its affiliates (Direct Testimony of Ray Williamson, Ex. S-1 at 7).

18 During cross examination, Mr. Williamson agreed that it may be reasonable to grant
19 interim approval of waivers to APS pending complete review. Accordingly, Staff's proposal is that
20 any approval of the waivers and exemptions requested by the Agreement be made interim, pending
21 a full industry-wide examination of the appropriate regulatory scheme following industry restructure.

22 **IV. CONCLUSION**

23 Contrary to the arguments by the Council, the Commission may lawfully approve this
24 Agreement. Staff suggests that any approval should include a number of specific findings. First,
25 the Commission should indicate that the purpose of the Agreement is to approve rates for the new
26 service of direct access, not to consider the justness and reasonableness of existing rates, which are
27 presumed to be just and reasonable. The Commission should note that APS will be voluntarily
28 foregoing revenue as a result of the rate reductions provided in the Agreement. Despite the fact that

1 no finding of fair value or reasonable rate of return is necessary under these circumstances, sufficient
2 evidence exists to support such a finding, and the Commission should include the fair value findings
3 in its order.

4 The Commission should require, as a condition to approval, that Section 2.8 of the
5 Agreement be amended to provide that the Commission or its Staff may commence rate change
6 proceedings under conditions paralleling those provided to the utility, including response to petitions
7 submitted under A.R.S. § 40-246. Approval of the Agreement should not be permitted to supercede
8 or otherwise foreclose the Commission's authority to issue rules or other regulatory orders. The
9 Commission should decline to be made a party to the Agreement. Indeed, the Commission should
10 specifically find that the order approving the Agreement is a regulatory order, binding upon the
11 regulated entities, but without contractual effect upon the Commission.

12 The Commission should adopt Staff's proposed modifications to the unbundled tariffs
13 as a condition to the approval of the Agreement. Specifically, the Commission should require that
14 the unbundled tariffs be modified to provide an identifiable MGC, that direct access tariffs be made
15 directly comparable to standard offer tariffs, and that MGCs be increased, while providing for
16 concomitant decreases in the CTC and extension of the recovery period if necessary to accommodate
17 the increased MGCs.

18 Finally, any waivers and approvals required to implement the Agreement should be
19 made interim. The commission should direct commencement of a process to establish industry-wide
20 standards for applicability of regulatory processes, statutes and rules. With the conditions and
21 modifications described herein, Staff recommends approval of the Agreement.

22 RESPECTFULLY SUBMITTED this 5th day of August, 1999.

23
24
25 By: Christopher C. Kempley
26 Paul A. Bullis
27 Christopher C. Kempley
28 Janet M. Alward
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1 Original and ten copies of the
2 foregoing filed this 5th day
of August 1999 with:

3 Docket Control
4 Arizona Corporation Commission
1200 West Washington Street
5 Phoenix, Arizona 85007

6 A copy of the foregoing was
e-mailed and mailed this 5th day
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By Mary Ippolito