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ORIGINAL

EXCEPTION

BEFORE THE ARIZONA CORPORATION COMMISSION
AZ CORP COMMISSION

CARL J. KUNASEK,
Chairman
JIM IRVIN,
Commissioner
WILLIAM A. MUNDELL,
Commissioner

SEP 7 12 40 PM '99

DOCUMENT CONTROL

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.C.C R14-1-1601 }
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

Arizona Corporation Commission
DOCKETED

SEP 07 1999

DOCKETED BY

**ENRON CORP.'S EXCEPTIONS TO
RECOMMENDATION OF HEARING OFFICER**

Pursuant to the procedural notice issued by the Arizona Corporation Commission ("Commission") on August 26, 1999, Enron Corp. ("Enron") hereby files its exceptions to the recommendation of the Hearing Officer published in the form of an Opinion and Order ("Recommended Decision") on August 26, 1999 in the instant proceeding.

As a preface to our exceptions, Enron acknowledges that the Hearing Officer had a very difficult task in this case: balancing the interests of competition, the desires of the traditional Arizona Public Service Company's ("APS") customer base and the bottom line of what would be acceptable to APS. These are the very same tensions that have

made this Commission's job of setting the rules to govern restructuring so arduous. The advantages of a settlement: earlier implementation of open access, conservation of resources and avoiding litigation are laudable objectives. But this Settlement has a much loftier goal, to expeditiously bring the benefits of competition to APS's retail customers. The Settlement, even as revised by the Recommended Decision, will fall far short in this.

However attractive the notion of a settlement is, Enron contends that a settlement such as the one at issue in this case, one that keeps APS in a risk-free position but fails to create a market that will attract competitors, is no better than continuing the status quo. In fact, we would argue that it is far worse, since APS will be the beneficiary of light-handed regulation under the Settlement, even as it continues to exert monopoly power in the market place. In our exceptions we outline the changes which we believe are necessary to make the post-settlement environment a workably competitive one.

Summary of Position

The Commission must keep its eye on the prize in this proceeding. The goal of this case is to open the retail electric market served by APS to competition because the Commission has determined that competition best serves the public interest. The goal of this proceeding is not to bring rate reductions to consumers through regulation, it is not to grant APS a risk-free transition into the competitive marketplace and it is not to guarantee any ESP, APS, or any other provider of competitive services a profit. The Commission, if it is committed to creating competitive markets, cannot allow APS to move its market power into a deregulated environment. Parties to the Settlement have thrown out a red herring -- which the Recommended Decision apparently has caught -- that ESPs want guaranteed profit margins. ESPs are at complete risk in the competitive market; they

have no guarantee that they will recover one cent of the investment they make to serve Arizona consumers. What ESPs do want is a viable market. The record contains absolutely no proof that the Settlement will create such a market. All the marketer participants, the parties who are out marketing power on a daily basis, have testified to the contrary.

From Enron's perspective, the Recommended Decision has two serious substantive flaws and one procedural flaw. Procedurally, the Recommended Decision fails to rise to the level of a reasoned decision, based on the record developed before it. Under Arizona law, a Commission decision must be supported by substantial evidence, and not be arbitrary or otherwise unlawful.¹ The Recommended Decision falls short of this standard. Enron raised, presented testimony on and briefed a number of issues that are not addressed in the Recommended Decision.² Elsewhere, the Recommended Decision makes findings as to issues without discussing the arguments raised by the parties against that position or addressing the evidence that contradicts that finding. Because of the time frame accorded the parties to file these exceptions, however, Enron will focus only on the substantive issues which have the potential to make or break the competitive future for APS customers.

The first substantive issue is the inadequacy of the shopping credit, which is the difference between the fully bundled standard offer rate which APS offers all retail customers and the direct access rates that APS will charge to customers taking service from ESPs. The Recommended Decision failed to improve the artificially created "shopping credit," leaving ESPs to compete with a standard offer rate they cannot begin

¹ *Arizona Corporation Commission v. Citizens Utilities Co.*, 120 Ariz. 184, 584 P.2d. 1175 (App. 1978).

to beat. The record in this case is replete with documentation that the shopping credit, which itself varies with the customer class and customer size, does not even cover wholesale energy prices. The shopping credit must be enhanced, not to give ESPs a guaranteed profit, but to give the market a chance to work.

The second substantive flaw lies in the Recommended Decision's failure to limit the market power APS will enjoy after competition begins. The impact of residual market power may be hard to quantify but is just as pernicious as any other market barrier. The Recommended Decision addresses market power only in the context of the generation affiliate. It simply requires APS to add language to the Settlement Agreement to reflect that (1) it will create a generation affiliate under the parent company, Pinnacle West; (2) it intends to procure generation for standard offer customers from the wholesale generation market, and (3) APS's generation affiliate could bid for that load but would otherwise have no automatic privilege to serve, *if this language properly states APS's intent*. While Enron believes that these statements are correct, one could interpret the Recommended Decision to have ruled that if this language does not reflect APS's intent, APS need not do anything. If APS intends to give its generation affiliate first crack at serving the Standard Offer, it merely does nothing. There is no mechanism in the Recommended Decision to enforce the one change to the Settlement it would make in this area.

The Recommended Decision allows APS to recover only 67% of the costs to form the generation affiliate. True, this will save consumers some money, but it does not in any way mitigate the market power that the APS generation affiliate will enjoy by virtue of

² Generation market power which APS and its generation affiliate would retain under the Settlement is perhaps the biggest issue unaddressed.

obtaining **all** of APS's competitive generation and other assets. The Commission must be cognizant of the dual purpose of the settlement in this regard: it is to lower rates to consumers and create a viable market for competitive suppliers. The Recommended Decision only bows to one of these goals.

The Recommended Decision addresses the concern a number of parties expressed that APS could subsidize the spun-off assets by manipulating the capital structure of APS and the generation affiliate. The Decision provides that the capital structure of APS will be scrutinized in its 2004 rate case. Delaying for 5 years the review of cross-subsidization and related issues is hardly a meaningful solution. By that time, all the damage that cross-subsidization and preferential treatment can do in an emerging market will have been done. The Recommended Decision also states that the Commission reserves the right to review and approve the actual asset transfers, although the mechanism for this is not specified, and is not contemplated in the Settlement itself.

Next, Enron has a major concern stemming from the delay APS has obtained in transferring its competitive generation assets to its affiliate. This transfer will not occur until the end of 2002. Thus, for the years 2000, 2001 and 2002, APS will be supplying standard offer service with the generation it continues to own and control, just as it does today. APS will not be required to competitively bid out the Standard Offer Service in this pre-transfer period and the record show that it has no intention of doing so. The Code of Conduct will be of no help here, as it governs the interplay between APS and its marketing affiliates, which are separate companies. The code does not cover the actions of a single company managing its own resources.

The final concern over market power comes from the allocation of risk in the Settlement. APS is seemingly able to set the Standard Offer price for power, and then to recover any shortfalls in later periods. This sets the stage for a successful predatory pricing scenario in which APS can set the Standard Offer price below market, keep out competitors, and then recover lost dollars through risk-free adjustments starting in 2004. If APS is to offer merchant service in a competitive market, then its risk profile must be the same as other competitors. It must offer a price and bear the market risk of that price. It cannot be permitted to offer a price and then recover, through regulated, non-bypassable charges, losses attributed to that price some years down the road. The Commission must not allow APS to accumulate undercollections during the settlement period for deferred recovery after the settlement period as this takes away the benefits of lower rates which the customers believe the settlement has provided, while undermining competition.

Exceptions

Exception No. 1: The Recommended Decision Erred in Leaving in Place a Shopping Credit which is Demonstrably Inadequate.

As the Hearing Officer noted, the most contentious issue in the proceeding was the "shopping credit" established in the Settlement. The shopping credit is the difference between the bundled Standard Offer rate available as a default service to APS's retail customers, and the Direct Access Rate available to customers who take service from ESPs. This difference effectively creates a cap on what the ESP can collect for its "generation" portion of service. The shopping credit must enable the ESP to recoup not only the cost of wholesale power, but also the retailing and ancillary costs the ESP incurs over and above the Direct Access rates. If APS had performed a functional cost-of-

service study and designed rates for standard offer and direct access service based on this study, then the difference between the standard offer and direct access rates would be a cost-justified, "natural" shopping credit. Since APS did not do such a study, the Settlement's "black box" attempt to set shopping credits is nothing more than an artificial division of costs. It does not reflect the true costs to either APS or the ESP in providing retail service as evidenced by the wide variance of the shopping credit between different customer classes and for different customer sizes within a class. Nonetheless, since APS has not unbundled its rates based on costs, the Commission must look at the shopping credit to see if it is adequate for competitive retail service.

The bottom line is that if the shopping credit is set too low, ESPs cannot supply energy to consumers. ESPs will not be able to recover the Direct Access portion of the rate, the generation component and the additive costs of providing retail service, because the resulting bundled ESP rate would then exceed the Standard Offer Rate. There are retailing costs which ESPs will incur and must be able to recover, over and above the unbundled services the Commission listed in its proposed Electric Competition Rules ("ECR").³ These are commodity acquisition and supply portfolio management, energy imbalance costs, planning reserves and certain functions related to metering, billing and customer handling. Furthermore, ESPs must also incur costs to comply with the Commission's ECR, which includes obtaining a CCN through a hearing process, reporting and complying with hourly interval metering requirements.

Enron Witness Kingerski and others testified that the shopping credit was too low for competition to occur. Mr. Kingerski presented a calculation which showed, as an example, that for a 500 kW customer with a 50% load factor, the shopping credit was

insufficient to cover the ESP's wholesale energy cost, much less the additional retail activities an ESP must perform.⁴ APS responded to this demonstration by arguing that the shopping credit was sufficient for at least certain customers in the 40 kW to 200 kW class, but omitted the fact that the shopping credit decreases as customer size increases. Mr. Kingerski explained that the shopping credit even for this group was insufficient, once APS's numbers are adjusted for current wholesale energy costs and the cost of hourly interval metering, which APS will require for the direct access customer.⁵ But even if the shopping credit works for some customers in a class, unless it works for all customers, the market will not bring choice to customers. Mr. Kingerski has shown that customers with single premise non-coincident peak demand load of 1 MW or greater will not be competitively viable, even though they will be eligible for competitive services under the Commission's ECR. Furthermore, even if there are potential opportunities for ESPs to compete and attract smaller commercial customers, ESPs must still meet the aggregation thresholds put forth in the ECR without the benefit of larger anchor customers.

Exception No. 2: The Recommended Decision Failed to Address the Potential for Market Power Abuse Inherent in the Two-Year Delay the Settlement Gives APS to Transfer its Competitive Assets

Section 4.1 of the Settlement allows APS to delay transferring its competitive assets to an affiliate until Dec. 31, 2002.⁶ Thus for the first three years of open markets, APS will continue to own and operate all of the competitive assets it now has, including generation and those assets associated with customer (revenue cycle) services. The

³ Order No. 61634.

⁴ Tr. at pp. 845-6, *see also* APS Witness Davis at Tr. p. 223, lines 15-18.

⁵ Oral Surrebuttal of H. Kingerski, Tr. at pp. 845, line 20 – 847, line 11.

interim Code of Conduct will not govern APS's activities during this three-year period, as Section 7.7 states that the interim Code will address inter-affiliate relationships. The Recommended Decision did not alter this provision. Both the Settlement and the Recommended Decision are completely silent on how APS will manage its competitive assets once the market opens but before it transfers those assets to an affiliate at the end of 2002. APS must explain how it will manage its generation and other competitive assets during this transition period, to avoid giving itself undue advantage over the ESPs in the marketplace. The Commission must eliminate the potential for APS to use these assets to make its services more attractive than those of competitors.

The delay in transferring generation and other assets has implications under the Commission's proposed ECR as well. R14-2-1606B requires the utility to supply the Standard Offer service "through the open market." The draft of R14-2-1606B issued by the Commission on August 26, 1999 states that the power purchased for standard offer service shall be acquired through "an open, fair and arms-length transaction with prudent management of market risks, including management of price fluctuations." If for the next three years APS retains all of its generation and uses it to supply the standard offer, it will be out of compliance with both the existing requirement that it purchase that power from the open market and the proposed requirement that it obtain power through an open, fair and arms-length transaction. Enron submits that at least one of the intents behind the various iterations of Rule 1606B is to prevent a utility from using its monopoly power to give it a more competitive product than ESPs can provide in the marketplace. If APS can skirt compliance with this rule by delaying the transfer of assets, there are serious

⁶ APS Witness Davis testified that while APS could transfer the assets at any time during that three-year period, it would likely not be done much before the 12/31/02 date, and that all assets will be transferred to

questions about the fairness of the marketplace in which ESPs are expected to compete with APS.

Enron's concern here is not merely academic. Enron Witness Dr. Rosenberg testified that APS might retain favorable purchase power contracts in the wires company, which would imbue Standard Offer service with competitive advantage.⁷ APS Witness Mr. Davis responded that in fact, the "only purchase power contract we have in terms of magnitude" is the Salt River Project power purchase contract. He testified that if APS has less Standard Offer service than the magnitude of that contract, they would transfer it to an affiliate, if not, then the contract would stay in the wires company, to supply its Standard Offer service.⁸ This is precisely the gaming that gives APS an unearned and unfair advantage in a competitive market. This should not be permitted.

The Commission must also clearly state how and when it will review the transfer of competitive assets from APS to its affiliate. The Recommended Decision states that the Commission will do so, but the Commission must expressly state the mechanism which it intends to use, so that we can ascertain if that mechanism will be timely and effective.

Exception No. 3: The Recommended Decision Erred in Failing to Address APS's Ability Under the Settlement to Underprice Standard Offer Service and to Recover Losses in Later Periods.

The Settlement contains several provisions that allow APS to defer recovery of costs for generation incurred by APS in providing Standard Offer Service. APS can use these deferred recovery provisions to make the Standard Offer more attractive to consumers during the settlement period, since APS can charge rates for this service that are lower than its actual costs. APS is under no obligation to set the standard offer price

GENCO simultaneously. Tr. at p. 334, line 4 through p. 335, line 8.

⁷ Enron Exhibit 1, Direct Testimony of A. Rosenberg, at p. 3.

to reflect market rates and has not done so. ESPs then must compete with APS's artificially low rate. Years down the road, the Settlement allows APS to recover, through an adjustment mechanism, the losses that it incurred in making these sales. If the Commission wants the APS standard offer to compete fairly with the ESP offerings, APS must live with its pricing decisions put forth in the Settlement just as ESPs must. It should not be able to collect through deferred recovery adjustments or any other mechanisms shortfalls in its generation pricing. An unfettered marketplace must give customers accurate and timely price signals. Customers do not get real price signals if they pay a Standard Offer rate in January 2000 and are then assessed additional adjustments in the year 2004 to recoup under-recoveries that occurred in January 2000.

Enron Witness Kingerski testified at the hearing on the settlement that provisions of the Settlement will enable APS to recover the costs it incurs in providing Standard Offer Service from all Standard Offer customers, with no risk to APS.⁹ While the Recommended Decision did make a change in Section 2.8, it did not alter APS's ability to file to recover standard offer costs under these sections. Section 2.5 allows APS to defer costs, including costs incurred in providing Standard Offer Service, for later full recovery through an adjustment mechanism. Section 2.8 authorizes APS to seek increases in its Standard Offer Rate, even during the rate freeze period prior to July 1, 2004, under certain conditions, which APS was unable to describe with any certainty at the hearing.¹⁰ This allows APS to sell Standard Offer below market or even below cost, making it impossible for ESPs to compete. APS is then able to recover any revenue

⁸ Tr. at pp. 1118-1119.

⁹ See Direct Testimony of Witness Kingerski, p. 9, lines 19-21, discussing Settlement sections 2.6 and 2.8. Section 2.6 allows APS to defer costs, including Standard Offer costs, for later full recovery through an

shortfalls through the adjustment mechanism in Section 2.6 or the safety valve provision in Section 2.8. This is an open invitation for APS to engage in predatory pricing, undermining both competition and the benefits of the rate decreases. The Commission should clarify that the Settlement precludes any rate increases for regulated services during the settlement period. Rate increases to Standard Offer rates for increased generation costs should be implemented on a timely basis, not masked through deferred recovery.

Exception 4: The Recommended Decision Fails to Adequately Protect Against Subsidization of Unregulated Services by Regulated Services.

The potential for cost-shifting between APS and its generation and marketing affiliates poses a real threat to competition. The Recommended Decision acknowledged this problem, stating “we share the concern that the non-competitive portion of APS not subsidize the spun-off competitive assets through an unfair financial arrangement.”¹¹ However, the Recommended Decision fails to adequately prevent this. The Recommended Decision states that the Commission will closely scrutinize the capital structure of APS in its 2004 rate case. If cross-subsidies occur in the year 2000 or 2001, or even 2002 or 2003, waiting until the year 2004 to rectify the situation is of absolutely no help to the marketplace. The damage to competition will have been long done.

Cross-subsidization does not only occur in the transfer of assets. The existing rate structure can contribute to subsidization. The distribution rate, for example, may be set above the actual cost of distribution, thus contributing to the recovery of generation costs. If the distribution rate in the direct access tariff is too high because it is subsidizing the

adjustment clause. Section 2.8 authorizes APS to seek increases in its unbundled or Standard Offer Rate even during the rate freeze period prior to July 1, 2004.

¹⁰ Cross Examination of APS Witness Davis, Tr. at p. 264, line 17 through p. 271, line 15..

below-cost generation component of the standard offer rate, the rates are by definition not just and reasonable. As a result APS will be able to keep retail customers through a subsidized product. This hurts the ratepayers who are shouldering that subsidy.

Absent functionally unbundled rates, we can be assured that some measure of the generation service is being recovered in the Direct Access rates, a clear situation where competitive services provided by third parties are subsidizing the regulated Standard Offer against which they compete. This aspect of subsidization must be addressed in a functional unbundling study which must be part of a rate proceeding. Putting this off for 5 years, as the Settlement does, just adds another barrier to competition.

Summary

The Recommended Decision improved upon the Settlement that was filed with the Commission. The Recommended Decision's ruling which establishes credits for competitive services (metering, billing and meter reading) at embedded, rather than avoided, costs is consistent with the notion of just and reasonable rates. It will allow ESPs to perform those services for its customers in more efficient, cost-effective and innovative ways. The revisions to the code of conduct and unbundled bill are also very positive steps. Unfortunately, as we explained above, there remain some very significant problems with the Settlement from an ESP's viewpoint. We understand that these are not easy problems to deal with and that the utility is adamantly opposed to any of the changes we propose. Given the position APS is in, and the position it will have if the settlement is approved per the Recommended Decision, it is easy to understand APS's resoluteness. APS is about to get the competitive market handed to it, without the fear of any meaningful competition, and with no downside risk. The Commission must take the long

¹¹ Recommended Decision at p. 10.

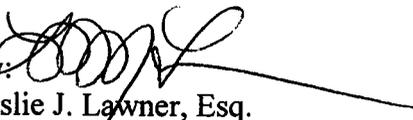
view of this Settlement and not sacrifice the competitive retail electric market for the sake of an expedient resolution of difficult issues.

WHEREFORE, Enron respectfully submits that the Recommended Decision be modified in accordance with the discussion above.

Dated: September 4, 1999

Respectfully submitted,

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