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BEFORE THE ARIZONA CORPORATION COMMISSION

RENZ D. JENNINGS  
CHAIRMAN  
MARCIA WEEKS  
COMMISSIONER  
CARL J. KUNASEK  
COMMISSIONER

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

DOCKET NO. U-0000-94-165

NOTICE OF FILING COMMENTS OF  
CITIZENS UTILITIES COMPANY

Citizens Utilities Company hereby provides notice of filing its Comments in the above-referenced docket.

DATED: November 8, 1996

Respectfully submitted,

*Beth Ann Burns*

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Associate General Counsel  
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Arizona Corporation Commission  
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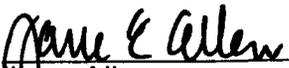
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COMMENTS OF  
CITIZENS UTILITIES COMPANY

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2901 N. Central Avenue, Suite 1660  
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November 8, 1996

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## I. INTRODUCTION

1  
2 Pursuant to the October 10, 1996 Procedural Order issued by the Arizona Corporation  
3 Commission ("Commission") in the above-captioned docket, Citizens Utilities Company  
4 ("Citizens" or "Company") submits the following comments on the proposed rule governing  
5 the introduction of retail electric competition in Arizona. Citizens previously filed comments  
6 in this proceeding on June 28 and September 12, 1996, and many of the concerns expressed  
7 in the Company's earlier comments are equally applicable to the most recent version of the  
8 proposed rules. In its present comments, however, Citizens will not repeat its prior  
9 statements, which are incorporated herein by reference, but will supplement its earlier  
10 comments and address issues raised for the first time by the Commission's most recent  
11 revisions to the proposed rules.

12 Citizens continues to support the Commission's decision to move the electric utility  
13 industry away from a system of regulated monopolies and toward a more competitive  
14 marketplace. Yet Citizens is concerned that the proposed rules, which establish goals and  
15 timetables for the introduction of competition, but which also leave unresolved a host of legal,  
16 financial and operational matters, are a work in progress which is miscast as binding rules.  
17 As a result, the Commission should treat the proposed rules as a starting point for the further  
18 development of comprehensive rules that will address the full range of issues that must be  
19 resolved in order to bring about an orderly transition to a more competitive market.

20 Citizens' comments are focused on four issues. First, the Company addresses the due  
21 process concerns raised by the number and magnitude of the issues unresolved by the  
22 proposed rules, concluding that the "framework" approach violates due process. Second, the  
23 comments discuss in detail the Commission's proposal for stranded cost recovery, explaining  
24 that the denial of a reasonable opportunity for affected utilities to recover their stranded costs  
25 would violate the regulatory compact and would be an unconstitutional taking. Third, Citizens  
26 requests that the Commission clarify that the provisions of the proposed rules addressing  
27 "mitigation" of stranded costs do not require utilities to divert revenues derived from collateral  
28 services to offset recoverable stranded costs. Finally, the comments discuss the proposed

1 rules' proposal for addressing the role of municipal utilities and other non-jurisdictional utilities  
2 in a competitive market, concluding that only where there is full and enforceable reciprocity  
3 will jurisdictional and non-jurisdictional utilities be able to compete on equal footing.

## 4 **II. THE PROPOSED RULES ARE IMPERMISSIBLY VAGUE**

5 The proposed rules are designed to facilitate monumental change in the structure and  
6 operation of the electric utility industry, moving affected utilities away from the traditional  
7 regulatory system in favor of a more competitive market for energy services. In so doing, the  
8 Commission sets out a time line for the implementation of retail competition, requiring  
9 affected utilities to make available all of their retail demand for competitive generation supply  
10 not later than January 1, 2003. Yet the rules put forth by the Commission to facilitate this  
11 transition is a "skeletal framework" which defers resolution of a host of essential issues and  
12 which fails to provide sufficient detail to enable affected utilities to conform to the rules. This  
13 lack of clarity and definition is contrary to basic principles of due process and fails to provide  
14 the reasoned basis and evidentiary support essential for any agency action to be sustainable.

### 15 **A. The Proposed Rules Defer Resolution of Essential Issues and Fail to Provide 16 Sufficient Detail of Their Regulatory Requirements**

17 A critical flaw in the proposed rules is the fact that they are, in many important  
18 respects, a work in progress. The Commission itself has characterized the proposed rules  
19 as merely a "framework" for the transition to a more competitive marketplace for the electric  
20 utility industry.<sup>1</sup> As a result, while the rules establish a binding time line for the  
21 implementation of retail competition, at the same time the rules will be subject to further  
22 review and modification, creating a process whereby many of the specific requirements  
23 necessary for affected utilities to comply with the rules will not be known for some time.

24 The proposed rules do not resolve several key issues, including system reliability and  
25 safety, the treatment of stranded costs, the method for determining customer access to the  
26 competitive market prior to January 1, 2003, the features of unbundled and standard offer

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27 <sup>1</sup> See, e.g., Transcript of Commission October 8, 1996 Special Open Meeting  
28 Working Session at 4, 5, 14, 16, 126; Concurring opinion of Commissioner Carl J.  
Kunasek (October 9, 1996).

1 service, the method for calculating system benefits charges, and undefined "legal issues."  
2 Instead, these subjects are to be addressed by working groups to be created in accordance  
3 with specific provisions of the rules. These working groups are intended to examine each  
4 of these areas in greater detail and make recommendations to the Commission. Such  
5 recommendations appear to be non-binding, and it is not clear from the proposed rules what  
6 action, if any, the Commission is required to take in response to the working groups' reports.

7 The scope of the issues assigned to these working groups is enormous. With regard  
8 to stranded costs, the working group is charged with developing recommendations  
9 concerning all aspects of "the analysis and recovery of stranded costs." Similarly, essential  
10 determinations governing the rates for both unbundled and standard offer service will be  
11 addressed in a series of workshops, which will consider such matters as designation of  
12 appropriate test years, adjustments to test year data, metering requirements and protocols,  
13 and service characteristics, including voltage levels. Further, while the proposed rules  
14 establish a system benefits charge, the method to be used to calculate this charge is to be  
15 determined in a future workshop.

16 The Commission's determination to use working groups to resolve many of the  
17 complicated and contentious issues underscores the absence of finality and predictability of  
18 the proposed rules. For example, with regard to stranded costs, the working group is  
19 directed "to develop recommendations for the analysis and recovery of Stranded Costs."  
20 A.A.C. R14-2-1607(C). In preparing its recommendations, the working group is to consider  
21 the same factors to be considered by the Commission when determining the amount and  
22 recovery mechanism for individual utilities' proposals for stranded cost recovery. A.A.C. R14-  
23 2-1607(D).

24 By assigning these matters to a working group, the Commission has reserved the right  
25 to subsequently change virtually every aspect of the stranded cost provisions of the proposed  
26 rules in response to the working group's recommendations. Citizens agrees with the  
27 Commission that further study is required to address many of the difficult questions presented  
28 by the move to a more competitive market. However, it may be extremely difficult for

1 affected utilities to begin this transformation when key components of the rules mandating  
2 that change may themselves be changed at any time. The provisions of the rules must be  
3 known with certainty before utilities can make long-range decisions concerning the utilization  
4 of existing facilities, stranded cost mitigation, and the nature of the new services to be offered  
5 in a competitive market. Absent such certainty, affected utilities may be required to  
6 speculate as to what the final regulatory requirements will be, and cannot make a reasoned  
7 determination of how best to act to meet those requirements.

8 Moreover, apart from the matters assigned to working groups, many other aspects of  
9 the rules are vague and ambiguous. For example, A.A.C. R14-2-1603 would require electric  
10 service providers intending to offer jurisdictional "Competitive Services" to obtain a Certificate  
11 of Convenience and Necessity ("CC&N"), except to the extent that service is to be provided  
12 within the utility's distribution service territory. Yet the proposed rules do not identify or  
13 explain parties' competing rights under new or existing CC&Ns, or how the historic CC&N  
14 approach is to be applied in a market open to retail competition. Moreover, the proposed  
15 rules provide no guidance to assist affected utilities to define or maintain the boundaries  
16 between competitive and regulated services and customers. Further, A.A.C. R14-2-1607(A)  
17 would direct affected utilities to mitigate stranded costs, but provides no guidance concerning  
18 the specific mechanisms to be used or the extent to which related costs may be recovered  
19 through rates. Finally, the rules contain only the most skeletal framework with regard to their  
20 application to political subdivisions or municipal corporations. See A.A.C. R14-2-1611.

21 **B. The Failure of the Proposed Rules to Provide Detail Sufficient for Affected**  
22 **Utilities to Conform their Conduct to Comply with the Rules Violates Due**  
23 **Process**

24 Fundamental principles of due process reflected in the Fourteenth Amendment to the  
25 United States Constitution and Article 2, Section 4, of the Arizona Constitution require that  
26 regulatory mandates be articulated with reasonable precision and that they not be so vague  
27 or ambiguous that a reader "of common intelligence must necessarily guess at their meaning  
28 and differ as to their application." *Cohen v. State*, 121 Ariz, 6, 9, 588 P.2d 299, 302 (Ariz.  
1977). See *Cavco Industries v. Industrial Comm'n of Arizona*, 129 Ariz.429, 434, 631 P.2d

1 1087, 1092 (Ariz. 1981); *State v. Cota*, 99 Ariz. 233, 236-37, 408 P.2d 23, 26 (Ariz. 1965);  
2 *Southwest Engineering Co. v. Ernst*, 79 Ariz. 403, 412-13, 291 P.2d 764, 770-71 (Ariz. 1955).  
3 In *State Compensation Fund v. De La Fuente*, 18 Ariz. App. 246, 501 P.2d 422 (Ariz. App.  
4 1972), the court explained:

5 An act must be complete in all its terms when it leaves the legislature; so that  
6 those charged with the administration of such act are amenable to the courts  
7 for failure to put it into effect or for its maladministration, and so that everyone  
8 may know by reading the law what his rights are and how it shall operate when  
9 put into execution; and the court cannot supply material and essential  
10 omissions.

11 *Id.* at 251-52 (quoting 82 C.J.S. Statutes § 64 (1953)). This principle applies with equal force  
12 to regulations promulgated by the Commission. As the Supreme Court explained in  
13 *Securities and Exchange Commission v. Chenery*, 332 U.S. 194 (1947), "[i]t will not do for  
14 a court to be compelled to guess at the theory underlying an agency's action; nor can a court  
15 be expected to chisel that which must be precise from what the agency has left vague and  
16 indecisive. In other words, 'We must know what a decision means before the duty becomes  
17 ours to say whether it is right or wrong.'" *Id.* at 196-97 (quoting *United States v. Chicago, M.,  
18 St. P & P.R. Co.*, 294 U.S. 499, 511 (1935)).

19 The proposed rules fall far short of this required level of detail and clarity and are  
20 therefore invalid. As noted above, the proposed rules defer decisions on several essential  
21 issues and are in many instances vague and ambiguous, such that neither an affected utility  
22 nor a reviewing court can determine the exact requirements of the proposed rules. As such,  
23 the proposed rules fail to satisfy the minimum requirements for due process. Affected  
24 utilities, electric service providers, and other participants in the market for energy services,  
25 have the right to know how they will be regulated at the time the rule is adopted. It is not  
26 legally sufficient for the Commission to simply promulgate a framework and then order  
27 Citizens and other affected utilities to restructure their business in conformity with ill-defined  
28 rules that are subject to further change.

**C. The Commission Should Reclassify the Proposed Rules as a General Statement of Policy**

Because the proposed rules leave issues unresolved and set out procedures for further

1 administrative action intended to clarify and expand upon the current outline, the Commission  
2 should treat the current proposal as a general statement of policy. Reclassifying the  
3 proposed rules in this manner would enable the Commission to retain the existing framework  
4 of the proposed rules, while continuing to study the host of unresolved issues and examining  
5 the need for further changes to the rules, without causing the unfinished business from  
6 undermining the viability of the balance of the proposed rules.

7 While policy statements may set forth the Commission's intended approach to electric  
8 industry restructuring, to which affected utilities may be required to conform, a policy  
9 statement will not have binding legal effect. Instead, the final determination concerning  
10 affected utilities' rights and obligations would be made in a subsequent rulemaking or other  
11 proceeding. For example, in *Pacific Gas & Electric Co. v. Federal Power Comm'n*, 506 F.2d  
12 33 (D.C. Cir. 1974), the Court of Appeals reviewed a Federal Power Commission ("FPC")  
13 order concerning natural gas curtailment priorities. The D.C. Circuit concluded that the order  
14 did not "establish a 'binding norm'" and was not "finally determinative of the issues or rights  
15 to which it is addressed." *Id.* at 38. Instead, the FPC's order "merely announced the general  
16 policy which the [FPC] hopes to establish in subsequent proceedings." *Id.* at 41. Where an  
17 agency is not yet prepared to provide the full quantum of evidence needed to support a  
18 substantive rule, it may proceed by means of a policy statement to specify its intended  
19 approach while deferring resolution of matters that require further deliberation.

20 Thus, to the extent that the proposed rule are intended to serve as a framework for  
21 future action, but do not contain the "type of mandatory, definitive language" that [is] "a  
22 powerful, even potentially dispositive, factor" in determining whether agency action constitutes  
23 a rule, *McClouth Steel Prods. Corp. v. Thomas*, 838 F.2d 1317, 1321 (D.C. Cir. 1988), the  
24 proposed rules' provisions governing issues such as stranded costs, the rates, terms and  
25 conditions of unbundled services, and the timing of the implementation of competitive  
26 services, should be declared to be a policy statement to be implemented through a separate  
27 proceeding. By proceeding in this manner, the Commission may retain the framework of the  
28 proposed rules while continuing its efforts to resolve the many outstanding issues.

1                   **III. THE PROPOSED RULES SHOULD BE REVISED TO ENSURE**  
2                   **A REASONABLE OPPORTUNITY FOR FULL RECOVERY OF**  
3                   **STRANDED COSTS**

4                   With regard to the recovery of stranded costs, the proposed rules reflect several  
5                   important changes from the draft rules issued by the Commission on August 28, 1996, most  
6                   notably the inclusion of power purchase contracts and other costs not directly attributable to  
7                   a utility's generation assets within the definition of stranded costs and the shift away from a  
8                   discretionary approach to stranded cost recovery. Citizens believes these changes are  
9                   absolutely essential in order to address the full range of stranded costs and applauds the  
10                  Commission for amending its earlier proposal to provide greater certainty that costs prudently  
11                  incurred by affected utilities in order to meet their public service obligations shall be  
12                  recovered in the course of the transition to a more competitive marketplace for energy  
13                  services.

14                 As a result of these revisions to the draft rules, Citizens' comments begin from the  
15                 proposition that stranded costs are recoverable, and the comments that follow are intended  
16                 to ensure that this approach is reflected fully in the balance of the proposed rules. This  
17                 portion of Citizens' comments is arranged in four parts. First, the comments summarize the  
18                 key provisions of the proposed rules' stranded cost provisions. Second, the comments  
19                 discuss the legal bases requiring that utilities have a reasonable opportunity for full recovery  
20                 of stranded costs, concluding that such stranded cost recovery is required to prevent the  
21                 regulatory changes designed to promote retail competition from amounting to an  
22                 unconstitutional taking. Third, the comments address the application of the filed rate  
23                 doctrine, which prohibits the Commission from imposing rate conditions that prevent utilities  
24                 from recovering through retail rates the costs of wholesale power purchase contracts  
25                 approved by the Federal Energy Regulatory Commission ("FERC"). Finally, the comments  
26                 set out Citizens' specific recommendations for changes to the proposed rules' stranded cost  
27                 provisions.  
28

1 | **A. Summary of the Proposed Rules**

2 | The proposed rules state clearly that "[s]tranded costs are recoverable."<sup>2</sup> However,  
3 | the rules do not specify a generic mechanism to be used for recovery of stranded costs.  
4 | Rather, affected utilities are directed to estimate their stranded cost exposure and file with  
5 | the Commission individual proposals for recovery of such costs. Affected utilities are also  
6 | required to mitigate stranded costs through "every feasible, cost-effective measure."

7 | In response to individual utility's filings to implement stranded cost recovery  
8 | mechanisms, the proposed rules state that the Commission will balance a variety of factors<sup>3</sup>

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9 | \_\_\_\_\_  
10 | <sup>2</sup> October 1, 1996 Memorandum From Utilities Division to Arizona Corporation  
11 | Commission at 3.

12 | <sup>3</sup> The proposed rules list the following 11 factors to be considered by the  
13 | Commission:

- 14 | 1. The impact of stranded cost recovery on the effectiveness of competition;
- 15 | 2. The impact of stranded cost recovery on customers of the affected utility  
16 | who do not participate in the competitive market;
- 17 | 3. The impact, if any, on the affected utility's ability to meet debt obligations;
- 18 | 4. The impact of stranded cost recovery on prices paid by customers who  
19 | participate in the competitive market;
- 20 | 5. The degree to which the affected utility has mitigated or offset stranded  
21 | cost;
- 22 | 6. The degree to which some assets have values in excess of their book  
23 | values;
- 24 | 7. Appropriate treatment of negative stranded cost;
- 25 | 8. The time period over which stranded cost charges may be recovered. The  
26 | Commission shall limit the application of such charges to a specified time  
27 | period;
- 28 | 9. The ease of determining the amount of stranded cost;
10. The applicability of stranded cost to interruptible customers; and

1 to determine the manner and extent to which utilities may recover stranded costs. Such  
2 filings shall be supported by estimates of the utilities' unmitigated stranded cost exposure.  
3 The specific proposals for stranded cost recovery will be addressed at a hearing at which the  
4 Commission Staff, the affected utilities, and intervenors may address the appropriate  
5 "mechanisms and charges" for stranded cost recovery.

6 Yet the proposed rules also impose significant restrictions on a utility's potential  
7 recovery of stranded costs. First, the proposed rules specify that stranded costs may be  
8 recovered only from "customer purchases made in the competitive market" under the  
9 provisions of the proposed restructuring. At a minimum, this serves to postpone by several  
10 years the implementation of stranded cost recovery, which will be subject to the same phase-  
11 in as retail competition. Further, the proposed rules provide that "[a]ny reduction in electricity  
12 purchases from an affected utility resulting from self-generation, demand-side management,  
13 or other demand reduction attributable to any cause other than the retail access provisions  
14 of this Article shall not be used to calculate or recover any Stranded Cost from a consumer."  
15 Finally, the proposed rules include a limited right for affected utilities to adopt "distribution  
16 charges or other means of recovering unmitigated stranded costs," but specify that such  
17 mechanisms may only be applied to existing customers "who reduce or terminate service  
18 from the Affected Utility as a direct result of competition governed by this Article, or who  
19 obtain lower rates from the Affected Utility as a direct result of the provisions of this Article."

20 **B. Utilities are Entitled to a Reasonable Opportunity to Fully Recover Their**  
21 **Stranded Costs**

22 While Citizens is largely supportive of the stranded cost provisions of the proposed  
23 rules, aspects of the proposed rules should be revised to clarify that affected utilities will be  
24 provided a reasonable opportunity to recover fully their stranded costs. As the following  
25 discussion will demonstrate, an opportunity for full stranded cost recovery is mandated by the  
26 regulatory compact pursuant to which Citizens and other affected utilities incurred the costs

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27  
28 11. The amount of electricity generated by renewable generating resources  
owned by the affected utility.

1 that may be stranded as a result of the introduction of retail competition. Further, such  
2 stranded cost recovery is required by fundamental principles of constitutional law, which hold  
3 that when changes in government regulation adversely impact a utility's ability to recover its  
4 costs, either through an actual taking or through establishment of rates that are so low as to  
5 be confiscatory, the utility must be compensated fully for the resulting loss. The changes to  
6 the proposed rules urged by Citizens are designed to ensure that these fundamental legal  
7 and regulatory principles are reflected fully in the final rules.

8 **1. Stranded costs are the result of changes in law and policy**

9 The proposed rules accurately classify stranded costs as costs attributable to  
10 Commission-initiated regulatory changes. The proposed rules define stranded costs as the  
11 verifiable net difference between:

- 12 (a) the value of all the prudent jurisdictional assets and obligations necessary to  
13 furnish electricity (such as generating plants, purchased power contracts, fuel  
14 contracts, and regulatory assets), acquired or entered into prior to the adoption  
15 of this Article, under traditional regulation of Affected Utilities, and  
16 (b) the market value of those assets and obligations directly attributable to the  
17 introduction of competition under this Article.

18 A.A.C. R14-2-1601(8).

19 Citizens supports this definition of stranded costs. The Commission's use of  
20 "stranded costs" in place of the prior draft's more limited "stranded investment" accurately  
21 reflects the fact that the types of costs which will be stranded as a result of the move to  
22 competition will include a much wider array of costs beyond existing jurisdictional assets.  
23 Moreover, this definition correctly states that stranded costs are created as a result of the  
24 changes from "traditional regulation" and "the introduction of competition" by the Commission  
25 through regulatory change.

26 **2. Disallowance of stranded cost recovery violates the regulatory compact**

27 In the proposed rules, the Commission recognizes that stranded costs arise from the  
28 profound regulatory changes required to move the electric utility industry from a system of  
regulated monopolies to a more competitive market, and that utilities should be allowed to  
recover costs incurred in reliance on the continuation of the previous regulatory system.

1 Arizona utilities, like utilities throughout the United States, have been charged with the  
2 obligation to serve all customers within a defined service area and are restricted in the  
3 amount they may charge for their service to rates that allow for a reasonable return on and  
4 of utility investments made in order to meet the obligation to serve. This obligation to serve  
5 coupled with a right to a reasonable return comprises the regulatory compact that is at the  
6 heart of government regulation of public utilities. As Judge (now Justice) Scalia has  
7 explained, "the very nature of government rate regulation" is "a compact whereby the utility  
8 surrenders its freedom to charge what the market will bear in exchange for the state's  
9 assurance of adequate profits." *New England Coalition on Nuclear Pollution v. Nuclear*  
10 *Regulatory Comm'n*, 727 F.2d 1127, 1130 (D.C. Cir. 1984). See *Application of Trico Electric*  
11 *Co-operative, Inc.*, 92 Ariz. 373, 380-81, 377 P.2d 309, 314-15 (Ariz. 1962).

12 Under Arizona law, utilities are required to provide safe and adequate service. A.R.S.  
13 §40-321(A) provides:

14 When the commission finds that the equipment, appliances, facilities or service  
15 of any public service corporation, or the methods of manufacture, distribution,  
16 transmission, storage or supply employed by it are unjust, unreasonable,  
17 unsafe, improper, inadequate, or insufficient, the commission shall determine  
18 what is just, reasonable, safe, proper, adequate or sufficient and shall enforce  
19 its determination by order or regulation.

20 A.R.S. §40-361(B) similarly provides:

21 Every public service corporation shall furnish and maintain such service,  
22 equipment and facilities as will promote the safety, health, comfort, and  
23 convenience of its patrons, employees and the public, and as will be in all  
24 respects adequate, efficient and reasonable.

25 Accordingly, utilities are obligated to supply electricity as a public service to all  
26 customers that require it, and, as part of this regulatory compact, the State agrees to provide  
27 the utility with the exclusive right to serve all customers within a defined territory. In  
28 *Application of Trico Electric Co-operative, Inc.*, 92 Ariz. 373, 377 P.2d 309 (Ariz. 1962), the  
Arizona Supreme Court explained:

In the performance of its duties with respect to public service corporations the  
Commission acts as an agency of the State. By the issuance of a certificate  
of convenience and necessity to a public service corporation the State in effect  
contracts that if the certificate holder will make adequate investments and

1 render competent and adequate service, he may have the privilege of a  
2 monopoly as against any other private utility.

3 *Id.* at 380-81.

4 This obligation to serve exists in tandem with the utilities' right to charge rates that  
5 permit recovery of the costs of service and a reasonable rate of return. A.R.S. §40-361(A)  
6 states this principle clearly:

7 Charges demanded or received by a public service corporation for any  
8 commodity or service shall be just and reasonable. Every unjust or  
9 unreasonable charge demanded or received is prohibited and unlawful.

10 See also Arizona Constitution, Article 15, Section 3 (enumerating powers of Commission).  
11 The courts have consistently held that just and reasonable rates shall provide utilities with  
12 the opportunity to recover their costs and to earn a return on their investment. See, e.g.,  
13 *Duquense Light Co. v. Barasch*, 488 U.S. 299, 307, 314 (1989); *Bluefield Waterworks &*  
14 *Improvement Co. v. Public Service Comm'n of W. Virginia*, 262 U.S. 679, 692-93 (1923);  
15 *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 153, 294 P.2d 378, 383 (Ariz.1956);  
16 *Scates v. Arizona Corporation Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (Ariz.  
17 App. 1978).

18 To the extent that the Commission's proposed rules would put utilities at risk to  
19 underrecover stranded costs, the rules would violate this regulatory compact. In reliance on  
20 the continuing obligation to serve, Citizens, like other utilities, made substantial investments  
21 in physical assets and entered into long-term contracts with wholesale power suppliers in  
22 order to continue to meet its public service obligations. Investors were willing to underwrite  
23 these long-term investments in reliance upon the existing regulatory regime which provided  
24 Citizens the ability to recover its costs, and earn a reasonable return on its investment,  
25 through the collection of Commission-prescribed just and reasonable rates. A change in  
26 regulatory policy that has the effect of preventing the Company from recovering the costs it  
27 incurred in reliance on the continuation of the pre-existing regulatory policy would violate this  
28 long-standing regulatory compact.

1 In recognition of the long-term investments made by public utilities in reliance upon  
2 the continuation of the regulatory compact, abrupt changes in regulatory policy have been  
3 found to violate the regulatory compact in a manner that requires that the affected entity be  
4 compensated for its resulting injury. In *United States v. Winstar Corp.*, 116 S. Ct. 2432  
5 (1996), the Supreme Court held that the government was responsible financially to a  
6 regulated business for the economic injury that resulted from a change in regulatory policy.  
7 The decision in *Winstar* concerned the impact of changes in federal legislation governing the  
8 accounting treatment for so-called "regulatory goodwill," which had the effect of reducing the  
9 book value of institutions that had acquired ailing thrift institutions in reliance on the prior  
10 policy to a level rendering many of them insolvent or in violation of regulatory capital  
11 requirements. The Court examined the nature of the relationship between the regulated  
12 entities and the regulatory authority and concluded that:

13 [I]t would have been irrational in this case for [the institution] to stake its very  
14 existence upon continuation of current policies without seeking to embody those  
15 policies in some sort of contractual commitment. This conclusion is obvious  
16 from both the dollar amounts at stake and the regulators' proven propensity to  
17 make changes in the relevant requirements. . . . Under the circumstances, we  
18 have no doubt that the parties intended to settle regulatory treatment of these  
19 transactions as a condition of their agreement. See, e.g., *The Binghamton*  
20 *Bridge*, 3 Wall. 51, 78 (1866) (refusing to construe charter in such a way that  
21 it would have been "madness" for private party to enter into it).

18 *Id.* at 2449; see also *id.* at 2472 ("It would, indeed, have been madness for [the institutions  
19 that acquired the thrifts] to have engaged in these transactions with no more protection than  
20 the Government's reading would have given them, for the very existence of their institutions  
21 would have been in jeopardy from the moment their agreements were signed") (plurality  
22 opinion).<sup>4</sup>

23 \_\_\_\_\_  
24 <sup>4</sup> This result is unaffected by the fact that the regulatory compact derives  
25 from long-established regulatory policies and practices rather than from specific  
26 contracts. The Commission's obligation to honor its regulatory commitments is derived  
27 from the relationship between the regulatory authority and the regulated entity and is not  
28 grounded on a specific instrument or contractual commitment. See, e.g., *Winstar*, 116  
S. Ct at 2452 (agreement to provide particular regulatory treatment "are especially  
appropriate in the world of regulated industries, where the risk that legal change will  
prevent the bargained-for performance is always lurking in the shadows"). Justice  
Scalia, in his concurring opinion, stated this point even more directly: a "promise to

1 Utilities made facilities investments and entered into long-term power purchase  
2 contracts based on the regulatory assurance that their prudent investments would be  
3 recoverable through rates. *Detroit v. Detroit Citizens' Street Railway Co.*, 184 U.S. 368, 385  
4 (1902) ("It would hardly be credible that capitalists about to invest money in what was then  
5 a somewhat uncertain venture, . . . would at the same time . . . give the right to the  
6 [government] to change at its pleasure from time to time those important and fundamental  
7 rights affecting the very existence and financial success of the company"). Moreover,  
8 because of the continuing obligation to serve and the long-range planning required for utilities  
9 to ensure adequate supplies to meet its public service obligations, utilities cannot readily  
10 retrade power purchase contracts or investments in generation assets in response to abrupt  
11 shifts in regulatory policy. Having ordered or sanctioned substantial investments by utilities  
12 upon the understanding that such investments would be recoverable through rates, the  
13 Commission may not now repudiate its obligation to provide the utilities a reasonable  
14 opportunity to recoup such investments and/or contractual commitments.

15 **3. Disallowance of stranded cost recovery is unconstitutional**

16 In is well established that property rights of regulated utilities enjoy constitutional  
17 protection. *Atlantic Coast Line R.R. v. North Carolina Corp. Comm'n*, 206 U.S. 1, 20 (1907).  
18 A Commission decision that would deny Citizens the ability to recover its stranded costs  
19 would constitute an uncompensated taking of private property in violation of the Fifth  
20 Amendment and Article II, Sections 4 and 17 of the Arizona Constitution. The Fifth  
21 Amendment's takings clause specifies that the government cannot "forc[e] some people alone  
22 to bear public burdens which, in all fairness and justice, should be borne by the public as a  
23 whole." *Dolan v. City of Tigard*, 114 S. Ct. 2309, 2316 (1994) (quoting *Armstrong v. United*  
24 *States*, 364 U.S. 40, 49 (1960)). Any determination by the Commission that would disallow  
25 the recovery through rates of the substantial investments made by Citizens in order to meet  
26 its public service obligations pursuant to a regulatory scheme that ensured it the opportunity

27 \_\_\_\_\_  
28 accord favorable regulatory treatment must be understood as (unsurprisingly) a *promise*  
to accord favorable regulatory treatment." *Id.* at 2477 (emphasis in original).

1 to recover its costs would unconstitutionally impose upon Citizens the full weight of costs that  
2 were incurred for the public benefit.

3 **a. The implementation of retail access without a reasonable**  
4 **opportunity for full stranded cost recovery will constitute an**  
5 **unconstitutional regulatory taking**

6 The Commission's proposal to phase in full retail electric competition beginning in  
7 1999 will require utilities to make available progressively greater portions of their transmission  
8 and distribution systems to customers that will acquire supplies from competing generation  
9 sources. This increased access to utility transmission and distribution systems will increase  
10 the likelihood of stranded investment, as utility-owned supply is displaced by competing  
11 suppliers.<sup>5</sup> Absent a reasonable opportunity for full recovery of associated stranded costs,  
12 this mandated unbundling of utility systems constitutes an unconstitutional taking.

13 In *Penn Central Transportation Co. v. New York City*, 438 U.S. 104 (1978) the  
14 Supreme Court, applying precedent dating back to *Pennsylvania Coal Co. v. Mahon*, 260  
15 U.S. 393 (1922), explained that government decisions that interfere with a property interest  
16 constitute a taking under the Fifth Amendment. *Penn Central* set out three factors to be  
17 considered to determine whether regulation "goes too far" and constitutes a taking: (a) the  
18 character of the government action, (b) the economic impact of the regulation, and (c) the

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19 <sup>5</sup> This mandatory third-party access to utility systems also constitutes a  
20 physical occupation of utility property which may constitute a taking. In *Loretto v.*  
21 *Teleprompter Manhattan CATV Corp.*, 458 U.S. 419 (1982), the Supreme Court,  
22 addressing a city ordinance authorizing cable television companies to install cable on  
23 private buildings, held that the physical presence of the cable on the owner's property  
24 was a taking that required compensation. *Id.* at 426 (a "permanent physical occupation  
25 is a taking without regard to the public interests that it may serve). The unbundling of  
26 utilities' transmission and distribution system is a similar physical occupation of private  
27 property in that competing energy suppliers are provided access to utilities' lines. *Cf.*  
28 *Florida Power Comm'n v. Florida Power & Light Co.*, 404 U.S. 453, 455-57 (1972)  
(noting that the transmission of electricity is a physical process). Moreover, it is not  
necessary for the physical occupation to be continuous for a taking to occur, only that  
the right to access be permanent. See *Nollan v. California Coastal Comm'n*, 483 U.S.  
825, 832 (1987) ("a 'permanent physical occupation' has occurred, for purposes of [the  
*Loretto*] rule, where individuals are given a permanent and continuous right to pass to  
and fro, so that the . . . property may continuously be traversed, even though no  
particular individual is permitted to station himself permanently upon the premises").

1 extent to which the regulation interferes with investment-backed expectations. When these  
2 factors are applied to the present case, it is clear that any disallowance of stranded costs  
3 would constitute a taking.

4 First, the character of the government action, the pervasive regulatory changes  
5 designed to transform the electric utility industry from a system of regulated monopolies to  
6 a competitive market, should not override utility investors "interest in continuing recovery of  
7 costs incurred in order to meet the utilities" public service obligations. This factor requires  
8 a balancing of the purpose and importance of the regulatory imposition with the competing  
9 private property interests. *Loveladies Harbor, Inc. v. United States*, 28 F.3d 1171, 1176  
10 (Fed. Cir. 1994). This analysis also looks to whether the means selected for obtaining the  
11 regulatory goal were reasonably designed to attain that goal. *Id.* In the present case, the  
12 failure to allow for full recovery of stranded costs does not bear a reasonable relation to the  
13 State's interest in promoting competition for energy services. The costs that would be  
14 rendered stranded as a result of the regulatory changes imposed by the Commission are  
15 costs that were incurred by Citizens as part of its public service obligations. There is no  
16 reasonable basis for concluding that the Commission's decision to promote competition  
17 requires the disallowance of costs incurred to provide service at rates previously held to be  
18 just and reasonable.

19 Second, the economic impact of this potential under recovery of costs is substantial.  
20 While there is at present no single, widely-accepted estimate of utilities' stranded cost  
21 exposure, estimates run into the hundreds of millions -- if not billions -- of dollars. These  
22 costs represent utilities' prudent investments, undertaken to serve the public and approved  
23 for inclusion in just and reasonable rates. Accordingly, while various parties may disagree  
24 as to the level of such stranded costs, there can be no doubt that the utilities have met the  
25 "threshold requirement that [they] show a serious financial loss from the regulatory  
26 imposition." *Loveladies Harbor*, 28 F.3d at 1177.

27 Third, it is beyond dispute that the disallowance of stranded cost recovery interferes  
28 with utility investors' reasonable investment-backed expectations. Citizens and other affected

1 utilities invested in physical assets, entered into power purchase contracts, and created  
2 regulatory assets with regulatory approvals and with the reasonable expectation that these  
3 costs would be recovered through future rates. Any disallowance of these costs will impair  
4 the investors' expectation of recovery of -- and of a return on -- these investments.<sup>6</sup> Any  
5 denial of an opportunity to recover these costs constitutes a governmental taking. As Justice  
6 Brandies explained, in *Missouri ex rel. Southwestern Bell Tel. Co. v. Public Service Comm'n*,  
7 262 U.S. 276 (1923):

8       The compensation which the Constitution guarantees an opportunity to earn is  
9       the reasonable cost of conducting the business. Cost includes not only  
10       operating expenses, but also capital charges. Capital charges cover the  
11       allowance, by way of interest, for the use of capital, whatever the nature of the  
12       security issued therefore; the allowance for risk incurred; and enough more to  
13       attract capital.

14 *Id.* at 291 (Brandies, J., concurring). The Commission's failure to allow for full stranded cost  
15 recovery plainly impairs these reasonable, investment-backed expectations.

16       When the *Penn Central* factors are considered together, it is clear that to the extent  
17 that the Commission mandates retail competition yet disallows an affected utility's full  
18 recovery of its stranded costs, any such under recovery will constitute an impermissible  
19 regulatory taking of the utilities' property.

20                   **b.    The implementation of retail access without a reasonable**  
21                   **opportunity for full stranded cost recovery will result in**  
22                   **confiscatory rates**

23       It is well-established that the Constitution both provides utilities with the right to a  
24 reasonable opportunity to recover -- and earn a reasonable return upon -- their prudent  
25 investments and prohibits state regulators from establishing rates at a level that would be  
26 confiscatory. *See, e.g., Duquense Light Co. v. Barasch*, 488 U.S. 299, 307, 314 (1989). This

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27       <sup>6</sup> Debt and equity securities issued by a public utility are investments in the  
28 same manner as comparable securities issued by any other business. *See Federal*  
*Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) ("the return to the  
equity owner should be commensurate with returns on investments in other enterprises  
having corresponding risks."). As a result, if the return to utility investors falls below the  
return available from other investments with equivalent risks, investors will shift their  
capital to earn the greater return.

1 precedent also holds that just and reasonable rates fall within a range of permissible rates  
2 which balances investor and ratepayer interests. See, e.g., *In re Permian Basin Area Rate*  
3 *Cases*, 390 U.S. 747, 767 (1968); *Federal Power Comm'n v. Hope Natural Gas Co.*, 320  
4 U.S. 591, 603 (1944); *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315 U.S. 575,  
5 585 (1942). Rates which fall below a just and reasonable level are confiscatory and in  
6 violation of the takings clause of the Fifth and Fourteenth Amendments. See, e.g.,  
7 *Duquense, supra*, at 307-8 (rate is confiscatory where it is "so unjust as to destroy the value  
8 of [the utility] property for all the purposes for which it was acquired.") (citing *Covington &*  
9 *Lexington Turnpike Road Co. v. Sanford*, 164 U.S. 578, 597 (1896)).

10 More than half a century ago, the Supreme Court, in *Bluefield Waterworks &*  
11 *Improvement Co. v. Public Service Comm'n of W. Virginia*, 262 U.S. 679 (1923), described  
12 the protections guaranteed to utilities (and utility investors):

13 The [allowed rate of] return should be reasonably sufficient to assure  
14 confidence in the financial soundness of the utility and should be adequate,  
15 under efficient economical management, to maintain and support its credit and  
enable it to raise the money necessary for the proper discharge of its public  
duties.

16 *Id.* at 692-93.

17 The Court elaborated on the standard to be applied to provide the constitutional  
18 protection of investor interests in *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S.  
19 591, 603 (1944):

20 [T]he investor interest has a legitimate concern with the financial integrity of the  
21 company whose rates are being regulated. From the investor or company point  
22 of view it is important that there be enough revenue not only for operating  
23 expenses but also for the service on the debt and dividends on the stock. . . .  
By that standard the return to the equity owner . . . should be sufficient to  
assure confidence in the financial integrity of the enterprise, so as to maintain  
its credit and to attract capital.

24 *Id.* at 603.

25 In Arizona, the Commission is charged with establishing just and reasonable rates, and  
26 in so doing will apply the general principle that the revenues derived from such rates "be  
27 sufficient to meet a utility's operating costs and to give the utility and its stockholders a  
28 reasonable rate of return on the utility's investment." *Simms v. Round Valley Light & Power*

1 Co., 80 Ariz. 145, 153, 294 P.2d 378, 383 (Ariz. 1956); *Scates v. Arizona Corporation*  
2 *Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (Ariz. App. 1978). The starting point  
3 for a determination of just and reasonable rates is the assessment of the fair value of the  
4 utility's property, which is used as the utility's rate base. Arizona Constitution, Article XV.  
5 The Commission must then apply a reasonable rate of return to this rate base to set a just  
6 and reasonable rate. *Arizona Corporation Comm'n v. Arizona Public Service Co.*, 113 Ariz.  
7 368, 370, 555 P.2d 326, 328 (Ariz. 1976).

8 The implementation of the Commission's proposed rules without a reasonable  
9 opportunity to fully recover the stranded costs that flow from the move to a more competitive  
10 marketplace for energy services will put utilities at risk for underrecovery of their costs of  
11 service and would deny utilities the ability to earn a return on their investment. The adoption  
12 of rates that would fall short of these constitutional requirements would constitute the  
13 confiscation of the utilities' property.

14 **C. State Regulatory Agencies May Not Bar Recovery through Rates of the Costs of**  
15 **FERC-Approved Wholesale Power Purchase Contracts**

16 As Citizens noted in its initial comments, a substantial portion of the electricity it  
17 supplies to its customers is purchased at wholesale from a variety of suppliers. The rates  
18 paid by Citizens for this power are set by the FERC, which has exclusive jurisdiction over  
19 wholesale sales under the Federal Power Act. Because the FERC-approved wholesale rates  
20 comprise a key component of Citizens' wholesale costs, the filed rate doctrine, discussed  
21 further below, prohibits the Commission from adopting retail rates that prevent the full  
22 recovery of these costs. As a result, the filed rate doctrine will invalidate any approach to  
23 stranded cost recovery that leads to under recovery of these power purchase contract costs.

24 **1. A substantial portion of Citizens' electric power is acquired under**  
25 **wholesale power purchase contracts priced at FERC-approved rates**

26 Citizens has only limited generation assets and must rely primarily on purchased  
27 power contracts to meet its energy and capacity requirements. Indeed, the Company  
28 currently generates less than one percent of its total electricity supplies, acquiring the  
balance of its requirements through wholesale purchase contracts. Moreover, unlike utilities

1 that have substantial generating assets, Citizens does not earn a return on its substantial  
2 investments in these power purchase contracts.

3 The wholesale power contracts to which Citizens is a party are subject to federal  
4 regulation and are priced at FERC-approved rates. See, e.g., *Federal Power Comm'n v.*  
5 *Southern California Edison Co.*, 376 U.S. 205, 210-12 (1964). As a result, state regulatory  
6 commissions have no jurisdiction over such sales or the rates paid by Citizens or other  
7 affected utilities that purchase power at wholesale in the interstate market. See, e.g., *State*  
8 *of Utah v. FERC*, 691 F.2d 444, 446-48 (10th Cir. 1982).

9 **2. States may not prevent recovery through retail rates of FERC-approved**  
10 **wholesale costs**

11 The filed rate doctrine provides that FERC has exclusive jurisdiction over wholesale  
12 rates and that the rates filed with or approved by the FERC may not be altered at the state  
13 level. This preemptive authority is derived from the Federal Power Act, which states that the  
14 FERC shall determine whether electric wholesale rates are just and reasonable, and from the  
15 supremacy clause, which invalidates all state laws that conflict or interfere with an act of  
16 Congress.<sup>7</sup> See *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 963-64 (1986);  
17 *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571, 581-82 (1981). The Supreme Court first  
18 established the filed rate doctrine in *Montana-Dakota Utilities Co. v. Northwestern Public*  
19 *Service Co.*, 341 U.S. 246 (1951). In that case, petitioner alleged that the rates approved  
20 by the FPC were unreasonably high due to allegedly fraudulent conduct by an interlocking  
21 directorship and asked a federal court to apply a different rate to award damages. The Court  
22 applied principles of primary jurisdiction to conclude that the rate filed with and approved by  
23 the FPC is the only legitimate or reasonable rate and that a court is without jurisdiction to  
24 apply a different rate. *Id.* at 251-52. The Court refined this holding in *Arkansas Louisiana*  
25 *Gas Co. v. Hall*, 453 U.S. 571 (1981), to rely expressly on preemption grounds. There, a

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26  
27 <sup>7</sup> This preemptive effect is also given to administrative regulations  
28 promulgated pursuant to Congressional authorization. *Kentucky West Virginia Gas Co.*  
*v. Pennsylvania Public Utility Comm'n*, 837 F.2d 600, 605 (3rd Cir.) (citing *Capital Cities*  
*Cable, Inc. v. Crisp*, 467 U.S. 691 (1984)), cert. denied, 488 U.S. 941 (1988).

1 seller of natural gas urged a state court to utilize a contract rate that exceeded the filed rate  
2 to calculate damages. The Court held that a state court may not substitute its judgement for  
3 the FERC, and could not apply a rate other than the rates on file with or approved by the  
4 FERC. *Id.* at 581-82.

5 In a decision which is highly instructive on this issue, *Nantahala Power & Light Co. v.*  
6 *Thornburg*, 476 U.S. 953 (1986), the Supreme Court addressed the impact of FERC's  
7 wholesale rate determination on state ratemaking authority. In *Nantahala*, the Court held  
8 that state regulatory commissions must allow for full recovery through retail rates of costs  
9 incurred by the payment of FERC-approved wholesale rates. Under this holding, the  
10 preemptive effect attaches not only to wholesale rates, but to all other FERC decisions  
11 "affect[ing] those rates." *Id.* at 966-67. Applying *Nantahala*, courts have held that state  
12 commissions may not question or alter the wholesale rates determined by FERC and may  
13 not bar local distribution companies from passing such costs through to local ratepayers.<sup>8</sup>  
14 See, e.g., *Mississippi Power & Light Co. v. Moore*, 487 U.S. 354, 372 (1988); *Kentucky*  
15 *West Virginia Gas Co. v. Pennsylvania Public Utility Comm'n*, 837 F.2d 600, 609, (3rd Cir.),  
16 *cert denied*, 488 U.S. 941 (1988).

17 The filed rate doctrine, which operates independently of the constitutional prohibitions  
18 against uncompensated takings discussed above, requires the Commission to enable  
19 Citizens and other comparable affected utilities to continue to recover through retail rates the  
20  
21

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22 <sup>8</sup> Courts have recognized exceptions to the strict application of the filed rate  
23 doctrine in limited cases. See, e.g., *Kentucky West Virginia Gas Co. v. Pennsylvania*  
24 *Public Utility Comm'n*, 837 F.2d 600, 609 (3rd Cir.), *cert. denied*, 488 U.S. 941 (1988)  
25 (filed rate doctrine will not bar a state from examining a utility's prudence in purchasing  
26 from one supplier at FERC-approved rates when lower FERC-approved rates were  
27 offered by another supplier); *Arkansas Power & Light Co. v. Missouri Public Service*  
28 *Comm'n*, 829 F.2d 1444, 1452 (8th Cir. 1987)(a state commission does not violate the  
filed rate doctrine if it delays the flow-through of FERC-approved costs where the costs  
are ultimately recovered in full). However, none of those exceptions enable the  
Commission to bar the recovery of wholesale rates paid under federally-mandated power  
purchase contracts.

1 costs of wholesale power purchase contracts. As a result, any approach to stranded cost  
2 recovery that would deny Citizens' full recovery of these costs will be invalid.

3 **IV. THE PROPOSED RULES SHOULD BE CLARIFIED TO ENSURE**  
4 **THAT REVENUES FROM COLLATERAL SERVICES ARE NOT**  
5 **IMPROPERLY ALLOCATED TO OFFSET STRANDED COSTS**

6 A.A.C. R14-2-1607(A) states that "Affected Utilities shall take every feasible, cost-  
7 effective measure to mitigate or offset Stranded Costs by means such as expanding  
8 wholesale or retail markets, or offering a wider scope of services for profit, among others."  
9 Citizens agrees with the Commission that utilities should act in a reasonable manner to  
10 mitigate stranded costs. However, there is a substantial difference between mitigation and  
11 the use of revenues from collateral services to reduce -- or "offset" -- the amount of stranded  
12 costs for which a utility may seek recovery. Accordingly, the proposed rule should be revised  
13 to ensure that the revenues from services unrelated to the incurrence of stranded costs are  
14 not diverted to offset recoverable stranded costs.

15 The concept of mitigation of damages is a basic principle of contract law, and is  
16 generally understood to mean that an injured party may not unreasonably fail to act, thereby  
17 allowing its damages to accumulate, and then seek to recover the damages that could have  
18 been avoided. See, e.g., C. McCormick, Handbook on the Law of Damages § 33 at 127  
(1935). Professor Corbin has explained:

19 It is not infrequently said that it is the "duty" of the injured party to mitigate his  
20 damages so far as that can be done by reasonable effort on his part. Since  
21 there is no judicial penalty, however, for his failure to make this effort, it is not  
22 desirable to say that he is under a "duty[.]" This recovery against the defendant  
23 will be exactly the same whether he makes the effort and mitigates his loss, or  
24 not; but if he fails to make the reasonable effort, with the result that his injury  
25 is greater than it would otherwise have been, he cannot recover judgment for  
26 the amount of his avoidable and unnecessary increase. The law does nothing  
27 to compensate him for the loss that he has helped to cause by not avoiding it.

28 A. Corbin, Corbin on Contracts §1039 at 242-43 (1964). Thus, with regard to stranded costs,  
the application of a mitigation theory would deny a utility recovery of stranded costs where  
it could be shown that the costs could have been avoided but for the utility's unreasonable  
acts or omissions. Citizens concurs with the Commission that utilities should take all  
reasonable efforts to mitigate avoidable stranded costs.

1 The proposed rules' reference to offset, however, would apply a very different  
2 approach. While mitigation is designed to encourage cost avoidance, offset is designed to  
3 reduce cost responsibility. As drafted, the proposed rules describe "expanding wholesale or  
4 retail markets" and "offering a wider scope of services for profit" as potential ways of offsetting  
5 stranded costs. This portion of the proposed rules appears to suggest that revenues derived  
6 from other aspects of affected utilities' operations, including aspects that bear no direct  
7 relation to the incurrence of stranded costs, should be used to reduce the level of stranded  
8 costs that would otherwise be eligible for recovery.

9 With regard to stranded costs, offset is an inappropriate remedy. Offset is comparable  
10 to the remedies of recoupment and counterclaim, and, like such remedies, is based on the  
11 presence of opposing -- or offsetting -- claims between two parties. See, e.g., *W.J. Kroeger*  
12 *Co. v. Travelers Indem. Co.*, 112 Ariz. 285, 287-88, 541 P.2d 385, 387-88 (Ariz. 1975); *Egan-*  
13 *Ryan Mechanical Co. v. Cardon Meadows Development Corp.*, 169 Ariz. 161, 170-71, 818  
14 P.2d 146, 156 (Ariz. App. 1990); *Morris v. Achen Construction Co., Inc.*, 155 Ariz. 507, 509-  
15 10, 747 P.2d 1206, 1208-09 (Ariz. App. 1986), *aff'd in part and rev'd in part on other*  
16 *grounds*, 155 Ariz. 512, 747 P.2d 1211 (Ariz. 1987). In this context, offset is used to reduce  
17 a prevailing party's award by the amount of a claim owed by it to the opposing party.<sup>9</sup> The  
18 responsibility for stranded costs, however, does not fit into this claim/counterclaim approach  
19 because utilities' stranded costs are the result of legal and regulatory changes, rather than  
20 conduct on the part of utilities or their customers that would give rise to offsetting claims by  
21 one against the other.

22 Further, both the doctrines of mitigation and offset distinguish collateral source  
23 payments, holding that payments from other sources, independent of and collateral to the

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25 <sup>9</sup> For example, in *Morris v. Achen Construction Co., Inc.*, *supra*, a  
26 homeowner sued a contractor for breach of contract and other claims arising from an  
27 agreement between the parties for the construction of a home in the Echo Canyon area.  
28 The contractor filed a counterclaim for amounts due pursuant to the contract and other  
claims. The court applied the doctrine of recoupment to offset the award payable to the  
homeowner for the contractor's breach by the amount due the contractor under the  
contract.

1 breaching party, received by the injured party are not to be used to diminish the injured  
2 party's damages. See, e.g., *Folkstead v. Burlington Northern, Inc.*, 813 F.2d 1377, 1380-81  
3 (9th Cir. 1987); *Russo v. Matson Navigation Co.*, 486 F.2d 1018, 1020 (9th Cir. 1973). For  
4 example, where a seller of goods has multiple items, the damages from a breach of contract  
5 are not mitigated by other sales that would ordinarily occur in the normal course of business.

6 The prohibition on the use of collateral source revenues to reduce a party's damages  
7 will be essential in the restructured market for energy services. Many of the new services  
8 that may be offered by affected utilities will result from new investments in new markets and  
9 will have no bearing on the utility's recovery of its exiting costs, including any stranded costs.  
10 These new investments will be made based on the opportunities available in the competitive  
11 market for such new services, one in which non-utility entrants will be competing with utilities  
12 for customers and investors solely on the basis of potential profits. The Commission should  
13 not unreasonably encumber these at-risk investments by mandating that the revenues  
14 derived from such new services be diverted to offset stranded costs.

15 Moreover, the use of incremental revenues as an offset to stranded costs may deny  
16 affected utilities a reasonable opportunity to recover their stranded costs. To the extent that  
17 collateral source revenues are used to reduce eligible stranded costs, utilities will be  
18 prevented from seeking recovery of such costs, which, in the absence of offset, could have  
19 been recovered. As detailed in Section III, *supra*, denial of a reasonable opportunity for a  
20 utility to recover its stranded costs violates the regulatory compact and constitutes an  
21 unconstitutional taking.

22 **V. THE COMMISSION SHOULD ACT TO MAINTAIN A LEVEL PLAYING**  
23 **FIELD WITH REGARD TO AFFECTED UTILITIES AND UTILITIES**  
24 **NOT SUBJECT TO THE COMMISSION'S JURISDICTION**

25 The proposed rules acknowledge that the Commission's jurisdiction does not extend  
26 to electric utilities of Arizona political subdivisions and municipal corporations (non-  
27 jurisdictional utilities). See A.A.C. §R14-2-1611. As a result, the Commission is without  
28 authority to require these non-jurisdictional entities to comply fully with the proposed rules.  
In response to this limitation on its jurisdiction, the Commission in the proposed rules

1 provides that: (a) the service territories of non-jurisdictional utilities shall not be open to  
2 competition and such utilities may not compete for sales in affected utilities' service  
3 territories, (b) jurisdictional utilities that are not affected utilities may participate voluntarily in  
4 the competitive market if such utilities open their own service territories to competition and  
5 obtain a CC&N, and (c) non-jurisdictional utilities may participate voluntarily in the competitive  
6 market if such utilities open their own service territories to competition, agree to all of the  
7 requirements of the proposed rules (other than the requirement that they obtain a CC&N),  
8 if adequate enforcement mechanisms can be established, and if all affected utilities consent  
9 in writing. In addition, the proposed rules state that the Commission will examine the need  
10 for additional legislation to address the role of non-jurisdictional utilities in a competitive  
11 market.

12 Citizens believes that the framework set out in the proposed rules represents a  
13 reasonable approach to issues presented by utilities not subject to the Commission's  
14 jurisdiction. In this regard, the overriding consideration is that the Commission act to  
15 maintain a level playing field, that is, that the Commission implement the move to competition  
16 in a manner that does not provide an unfair benefit to parties outside its jurisdiction, which  
17 may seek to take advantage of the benefits of a more competitive market without adhering  
18 fully to the obligations to be imposed by the proposed rules. To this end, Citizens supports  
19 the Commission's determination that a condition of any non-jurisdictional utility's ability to  
20 compete for sales in the service territory of an affected utility is the agreement by the non-  
21 jurisdictional utility to comply with all other applicable aspects of the proposed rules and the  
22 development of an appropriate enforcement mechanism. Only where there is such  
23 enforceable reciprocity will jurisdictional and non-jurisdictional utilities be able to compete on  
24 equal footing.

25 Ultimately, however, it appears that legislation may be required to address the role of  
26 electric utilities of political subdivisions and municipal corporations in a competitive market.  
27 Citizens intends to work with all of the interested parties to reach an equitable resolution of  
28 the difficult legal and policy issues raised by the move to competition.

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## VI. CONCLUSION

Citizens continues to support the transition to a more competitive market for energy services. However, as detailed above, Citizens is concerned that the failure of the proposed rules to address fully many of the most important issues raised by the transition to competition may undermine the Commission's goals and time table for the implementation of retail electric competition. Accordingly, Citizens urges the Commission to revisit the proposed rules and to adopt the specific recommendations contained in the present comments.

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Respectfully submitted,

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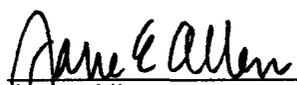
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