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**BEFORE THE ARIZONA CORPORATION COMMISSION**

1  
2 JIM IRVIN  
3 Commissioner-Chairman  
4 RENZ D. JENNINGS  
5 Commissioner  
6 CARL J. KUNASEK  
7 Commissioner

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8 IN THE MATTER OF THE  
9 COMPETITION IN THE PROVISION OF  
10 ELECTRIC SERVICES THROUGHOUT  
11 THE STATE OF ARIZONA.

DOCKET NO. RE-00000C-94-0165

**NOTICE OF FILING**

12 Pursuant to the Commission's Fifth Amended Procedural Order, dated January 29, 1998,  
13 Arizonans for Electric Choice and Competition, Cyprus Climax Metals and ASARCO hereby file  
14 the Second Rebuttal Testimony and Summary for Kevin C. Higgins, which witness is being  
15 sponsored jointly with Phelps Dodge, Ajo Improvement Company, and Morenci Water &  
16 Electric Company, in the above-captioned matter.

17 Respectfully submitted this 4th day of February, 1998.

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Arizona Corporation Commission

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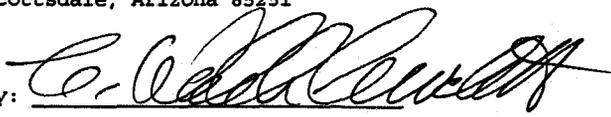
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**BEFORE THE ARIZONA CORPORATION COMMISSION**

**SECOND REBUTTAL TESTIMONY**

**OF**

**KEVIN C. HIGGINS**

**ON BEHALF OF**

**ARIZONANS FOR ELECTRIC CHOICE AND COMPETITION,  
BHP COPPER, CYPRUS CLIMAX METALS, ASARCO,  
PHELPS DODGE, AJO IMPROVEMENT COMPANY, AND  
MORENCI WATER & ELECTRIC COMPANY**

**IN THE MATTER OF THE COMPETITION IN THE PROVISION OF  
ELECTRIC SERVICE THROUGHOUT THE STATE OF ARIZONA  
DOCKET NO. RE-00000C-94-0165**

**February 4, 1998**

## **Second Rebuttal Testimony of Kevin C. Higgins**

### **Summary of Conclusions and Recommendations**

#### **Balancing of Customer and Utility Interests**

I agree with Dr. Rose (Staff), Dr. Rosen (RUCO), Dr. Coyle (City of Tucson), Dr. Cooper (Arizona Consumers Council), Mr. Smith (Navy), Ms. Pruitt (ACAA), and Mr. Lopezlira (Attny Gen), who recommend that utilities be at risk for recovery of a portion of strandable cost. I disagree with Mr. Dabelstein, who believes that parties advocating a sharing of responsibility for strandable cost should bear the burden of proof to demonstrate why customers should not be 100 percent responsible. Strandable cost recovery is an extraordinary proposition. On a forward-going basis, it represents payments from customers for *no services rendered*. Clearly, the burden is on the recipients to justify the appropriateness of the portion requested from customers, and not the other way round.

#### **Calculation Methods**

I support proposals for auction and divestiture, but also support having a viable administrative alternative. I am in general agreement with Dr. Coyle (City of Tucson) and Mr. Smith (Navy) that replacement cost valuation is the preferred administrative approach, although I reiterate my support for the specific proposal offered in my Direct Testimony, which incorporates both replacement cost valuation and net revenues lost approaches. In my proposal, net revenues lost is used to calculate strandable cost on a year-to-year basis over a three-to-five year period. This approach differs from the time period recommended by Dr. Rosen (RUCO) and Mr. Dabelstein, both of whom recommend that the calculation be carried out for the remaining life of the generation assets, some twenty to thirty years. I recommend against such a

long-term calculation, both because of the speculation involved and the desirability of avoiding a long-term true-up mechanism which perpetuates cost-of-service regulation.

Regarding the stock market valuation approach, I would be hesitant to commit Arizona customers to strandable cost payments based solely on a Wall Street determination of the value of split stock.

### **Mitigation**

I concur with the reasoning of Dr. Rose (Staff) and Mr. Smith (Navy) that mitigation of strandable cost is best encouraged by placing the utility at risk for a portion of its strandable cost.

### **Other Issues**

Mr. Neidlinger (Navy) asserts that special contract customers should pay strandable cost charges. However, the Rule in its current form limits strandable cost charges to those customers participating in retail access. Special contract customers are not in that group. Therefore, they do not pay strandable cost charges under the Rule. If strandable cost charges are extended to all standard offer customers, then the accompanying conditions I recommended in my Direct Testimony should also be adopted, namely: (1) The Standard Offer rate should be reduced by the amount of the transition charge, such that the final price for power paid by these customers is not increased, and (2) The Rule's existing treatment of self-generation, demand-side management, and other demand reductions unrelated to retail access should not be changed.

Collection of strandable costs through meter charges, as advocated by Dr. Block (Goldwater) and Mr. Lopezlira (Attorney General), based on historical usage may resolve the problem of economic distortions introduced by usage-based charges. However, the new set of equity and administrative problems this approach would introduce suggests that this recovery mechanism should be avoided.

Mr. Meek, Mr. Dabelstein, and Mr. Saline view price caps as requiring continued Commission regulation of generation prices. I reiterate that a price cap is an essential component of recovery mechanism design. In the context of stranded cost recovery, a price cap does *not* mean regulating the price of generation. Rather, it means designing the *transition charge* to accommodate the price cap objective.

Mr. Dabelstein suggests that it might be desirable to levy exit fees on self-generators. I disagree. Options such as self-generation and demand-side management have been available to customers for many years. Customers in the past have not been subject to stranded-cost-type penalties when exercising these options, and the advent of retail access should not be used as a pretext to start insulating utilities from these ordinary business risks now. There should be no exit fees levied on self-generators, nor should the reduction in electricity purchases resulting from self-generation be penalized with stranded cost charges.

Both Dr. Hieronymus (APS) and Dr. Rosen (RUCO) maintain that generation-related A&G costs should be included in strandable costs. I disagree. I note a subtle, but important, distinction. The net revenues lost approach uses projections of A&G costs in the *calculation* of strandable cost – but that is not the same as saying A&G costs are themselves strandable costs.

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1                   **SECOND REBUTTAL TESTIMONY OF KEVIN C. HIGGINS**

2

3                   **I. INTRODUCTION**

4   **Q.    Please state your name and business address.**

5   A.    Kevin C. Higgins, 39 Market Street, Suite 200, Salt Lake City, Utah, 84101.

6   **Q.    By whom are you employed and in what capacity?**

7   A.                I am employed by Energy Strategies, Inc. (ESI) as a senior associate. ESI  
8                    is a private consulting firm specializing in the economic and policy analysis  
9                    applicable to energy production, transportation, and consumption.

10   **Q.   On whose behalf are you testifying in this proceeding?**

11   A.                My testimony is being sponsored by Arizonans for Electric Choice and  
12                    Competition<sup>1</sup>, BHP Copper, Cyprus Climax Metals, Asarco, Phelps Dodge, Ajo  
13                    Improvement Company, and Morenci Water & Electric Company.

14   **Q.   Have you filed other testimony in this proceeding?**

15   A.                Yes. I have filed direct testimony and rebuttal testimony addressing issues  
16                    raised by witnesses sponsored by Affected Utilities.

17   **Q.   What is the purpose of this testimony?**

18   A.                I will provide rebuttal testimony which addresses issues raised by the  
19                    parties who are not Affected Utilities. I will assess these parties' basic approaches  
20                    to the critical questions of: (1) balancing customer and utility interests, (2)

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<sup>1</sup> Arizonans for Electric Choice and Competition is a coalition of energy consumers in favor of competition and includes Cable Systems International, BHP Copper, Motorola, Chemical Lime, Intel, Hughes, Honeywell, Allied Signal, Cyprus Climax Metals, Asarco, Phelps Dodge, Homebuilders of Central Arizona, Arizona Mining Industry Gets Our Support, Arizona Food Marketing Alliance, Arizona Association of Industries, Arizona Multihousing Association, Arizona Rock Products Association, Arizona Restaurant Association, Arizona Association of General Contractors, and Arizona Retailers Association.

1 calculation method, and (3) mitigation of strandable costs. I will then use this  
2 framework to evaluate the extent to which other parties' recommendations may be  
3 consistent with, or at variance with, the calculation/recovery/mitigation proposal I  
4 made in my Direct Testimony. In some cases, I will offer explanations to clarify  
5 apparent differences. I will also address some points of disagreement outside  
6 these three major questions.

## 7 **II. BALANCING OF CUSTOMER AND UTILITY INTERESTS**

8 **Q. In your direct testimony, you stated it was in the public interest for the**  
9 **Commission to balance customer and utility interests in implementing a**  
10 **strandable cost recovery program, and recommended that utilities be at risk**  
11 **for recovery of a substantial portion of strandable cost. Does the testimony**  
12 **of other witnesses support this view?**

13 **A.** Yes. This view is supported by the testimony of Dr. Rose (Staff), Dr.  
14 Rosen (RUCO), Dr. Coyle (City of Tucson), Dr. Cooper (Arizona Consumers  
15 Council), Mr. Smith (Navy), Ms. Pruitt (ACAA), and Mr. Lopezlira (Attny Gen).

16 Dr. Rosen and Dr. Cooper each testify that the portion of strandable cost  
17 assigned to customers should not be greater than 50 percent. Mr. Lopezlira  
18 recommends a customer share of 70 percent. Dr. Rose and Dr. Coyle do not make  
19 specific recommendations as to customers' share, but strongly recommend that it  
20 should be less than 100 percent. Mr. Smith does not make a specific  
21 recommendation, but points out that placing utilities at risk for recovery of some  
22 portion of strandable cost is an appropriate mitigation incentive.

1 **Q. How does your recommendation for sharing the risk of strandable cost**  
2 **compare with the specific proposals that were made by others?**

3 A. In my direct testimony, I recommend that the transition charge levied on  
4 customers should be designed to recover between 25 and 50 percent of a utility's  
5 strandable cost. On this general point, my recommendation is consistent with  
6 those of Dr. Rosen (RUCO) and Dr. Cooper (Arizona Consumers Council).  
7 However, my testimony also includes a specific proposal for an administrative  
8 calculation of strandable cost in which I suggest that the appropriate portion for  
9 customers should be in the lower-to-middle region of that range, e.g., 35 percent.  
10 In the context of that specific proposal, this lower customer share is warranted in  
11 order to accommodate the use of the net revenues lost approach over a three-to-  
12 five year period.

13 **Q. Do you believe that your 35 percent recommendation is low relative to Dr.**  
14 **Rosen's recommendation?**

15 A. Not necessarily. Dr. Rosen recommends the use of a net revenues lost  
16 calculation approach over an extended period, up to 22 years following  
17 introduction of retail competition. He projects that strandable cost for APS and  
18 SRP would be negative over that full period. For reasons I will discuss further in  
19 the next section, I do not favor using a net revenues lost approach over such an  
20 extended period of analysis. However, Dr. Rosen's analysis clearly illustrates the  
21 potential for shareholder benefit in a competitive market. This is consistent with  
22 my contention that deregulation of generation prices will mean that investors will  
23 have the opportunity over the long-run to earn above a regulated return. It is in

1 recognition of this long-term opportunity – and in recognition that a short-term  
2 analysis may overemphasize the impact of today’s excess capacity on strandable  
3 cost – that I recommend setting the transition charge at around 35 percent of year-  
4 to-year strandable cost, in my administrative proposal.

5 **Q. Are there parties who are not Affected Utilities who do not support placing**  
6 **the utility at risk for a portion of its strandable cost?**

7 A. Yes. Mr. Dabelstein, Ms. Firkins (IBEW), Ms. Petrochko (Enron), and Mr.  
8 Meek (Shareholders) support 100 percent recovery of strandable cost from  
9 customer charges. I disagree with this position and address this issue generally in  
10 my Direct Testimony [pp. 9-11] and previous Rebuttal [pp. 2-7]. Also, very  
11 convincing testimony in opposition to 100 percent recovery from customer  
12 charges is provided by Staff in Dr. Roses’s testimony, as well as by Dr. Rosen  
13 (RUCO) and Dr. Cooper (Arizona Consumers Council).

14 Mr. Dabelstein believes that parties advocating a sharing of responsibility  
15 for strandable cost should bear the burden of proof to demonstrate why customers  
16 should not be 100 percent responsible. I strongly disagree. Strandable cost  
17 recovery is an extraordinary proposition. On a forward-going basis, it represents  
18 payments from customers for *no services rendered*. Clearly, the burden is on the  
19 recipients to justify the appropriateness of the portion requested from customers,  
20 and not the other way round.

21 I also wish to address Mr. Dabelstein’s statement that even though many  
22 members of the Stranded Cost Working Group felt there should be sharing of  
23 stranded cost recovery between ratepayers and shareholders, “none of the parties

1 offered any substantive explanation or justification for requiring utility investors  
2 to assume any of the stranded cost.” [Dabelstein Direct, p. 42, lines 12-14] As  
3 one who participated actively in that working group, I can offer some insight here:  
4 Mr. Dabelstein, as chairman of the Working Group, expressly prevented this issue  
5 from being considered. He told the Working Group, over protests, that we were  
6 to proceed *as if* 100 percent recovery were assured. The determination of *whether*  
7 100 percent recovery should occur was not to be considered by our group.  
8 According to Mr. Dabelstein, this issue was to be determined elsewhere.

### 9 III. CALCULATION METHODS

10 **Q. How do you characterize the approaches of the non-utility parties with**  
11 **regard to the calculation of strandable cost?**

12 A. The non-utility parties’ positions fall into three broad categories: 1)  
13 Exclusive or very strong preference for a market approach [Ogelesby (PG&E),  
14 Petrochko (Enron), Lopezlira (Attny Gen), Block (Goldwater), Nelson (ECC)], 2)  
15 Preference for a market approach, if feasible, but with an administrative  
16 alternative proposed [myself, Smith (Navy), Pruitt (ACAA)], and 3) Preference  
17 for an administrative approach [Rose (RUCO), Coyle (City of Tucson),  
18 Dabelstein, Meek (Shareholders), Firkins (IBEW)].

19 **Q. What is your opinion regarding the market approaches that are being**  
20 **proposed?**

21 A. Mr. Ogelsby (PG&E) and Ms. Petrochko (Enron) advocate auction and  
22 divestiture. As I indicate in my Direct Testimony, I support this approach, when  
23 practicable. Dr. Block (Goldwater) and Mr. Lopezlira (Attny Gen) advocate a

1 stock market valuation approach that involves a splitting of utility stock into A  
2 shares and B shares. The A shares provide the investor the usual rights and  
3 benefits of a shareholder, while the B shares provide a claim against strandable  
4 cost [Block, Direct, p. 14]. Stranded cost is calculated as the difference between  
5 the book value of the company before deregulation and the value of the A share,  
6 measured at some pre-specified time. While I believe this approach is  
7 theoretically interesting, I am concerned that its implementation may not be  
8 viable. That is, there may be institutional and legal barriers to carrying out the  
9 proposed stock split. In addition, I am concerned about measurement issues. The  
10 stock valuation approach commits customers to paying for stranded cost based on  
11 the divergence between book valuation and the A shares as determined on Wall  
12 Street. We know that stock valuation is a dynamic process, affected by many  
13 variables internal and external to the firm; further, we know that the utilities in  
14 question are complex organizations – more than just generation companies. How  
15 can we be sure that the difference between book value and the A shares is a true  
16 measurement of strandable cost, and not the result of other dynamic changes in  
17 the financial marketplace? The answer is: we can't be sure, and I would be  
18 hesitant to commit Arizona customers to strandable cost payments based solely on  
19 a Wall Street determination of the value of A share stock.

20 **Q. What is your opinion regarding the administrative approaches that are being**  
21 **proposed?**

22 A. I am in general agreement with Dr. Coyle (City of Tucson) and Mr. Smith  
23 (Navy) that replacement cost valuation is the preferred administrative approach.

1           However, in my Direct Testimony, I make a specific proposal which incorporates  
2           both replacement cost valuation and net revenues lost approaches. In my  
3           proposal, net revenues lost is used to calculate strandable cost on a year-to-year  
4           basis over a three-to-five year period. This approach differs from the time period  
5           recommended by Dr. Rosen (RUCO) and Mr. Dabelstein, both of whom  
6           recommend that the calculation be carried out for the remaining life of the  
7           generation assets, some twenty to thirty years.

8   **Q.    Please explain your preference for using a three-to-five year calculation**  
9   **period instead of a twenty-to-thirty year period, if the net revenues lost**  
10 **approach is used.**

11   A.           As I explain in my Direct Testimony, the net revenues lost approach is  
12           very assumption-sensitive, and requires that projections be made concerning the  
13           annual operating and A&G costs which would have been incurred by the utility  
14           had competition not been introduced. In addition to the general objections I  
15           register about this approach, I am particularly concerned about the viability of  
16           projections of annual average market price and operating/A&G costs beyond a  
17           three-to-five year period. While Dr. Rosen (RUCO) demonstrates that a case can  
18           be made that annual strandable cost for APS may turn negative somewhere  
19           between years 6 and 8 (i.e., 2004-06) [Ex. RAR-4, p.2; RAR-5, p.4], I have little  
20           doubt that this “crossover year” can be moved further out in time by assuming  
21           higher utility operating costs. Because the market price and operating costs for  
22           such years are highly speculative, I am pessimistic that disputes over the  
23           appropriate projections for the “out years” can be readily resolved. One possible

1 remedy, the use of a long-term true-up mechanism to correct for miscalculations,  
2 is tantamount to maintaining a state of quasi-regulation of generation prices for  
3 the next twenty to thirty years, a prospect I consider to be at variance with the  
4 intent of the Competition Rule. For these reasons, if the net revenues lost  
5 approach is used, I recommend using a three-to-five year calculation/recovery  
6 period in combination with a transition charge designed to recover about 35% of  
7 expected strandable cost. (In addition, replacement cost valuation should be  
8 calculated to double-check the results of the net revenues lost estimation.)

9 **Q. Would it be reasonable to use the eight-year calculation period recommended**  
10 **by APS as a compromise between the three-to-five year period you**  
11 **recommend and the 22-year period recommended by Dr. Rosen?**

12 **A.** No. If Dr. Rosen's analysis is correct, the eight-year period recommended  
13 by APS corresponds to the approximate period that annual strandable cost for  
14 APS is positive. In Dr. Rosen's analysis, adding years of analysis beyond the  
15 eighth year brings the calculation of strandable cost down; likewise, truncating the  
16 analysis well before year eight does the same thing. Ending the analysis exactly at  
17 year eight may result in maximizing the strandable cost calculation to the benefit  
18 of the utility. [See Ex. RAR-5, p. 4]. Because the move to an "intermediate" time  
19 period probably benefits the utility from either direction, I do not consider an  
20 eight-year period to be a "middle ground" between Dr. Rosen's recommendation  
21 and my own. I see the question boiling down to whether a longer-term or shorter-  
22 term analysis is preferable. For the reasons given, I strongly prefer using the  
23 shorter period of analysis, with the stated qualifications.

1           **IV. MITIGATION**

2   **Q.    Do other parties recognize that mitigation of strandable cost is best**  
3           **encouraged by placing the utility at risk for a portion of its strandable cost?**

4   **A.            Yes. This point is recognized by Dr. Rose (Staff), Mr. Smith (Navy), and**  
5           **others. I concur with their reasoning on this issue. By their nature, mitigation**  
6           **actions are an integral part of corporate strategy that should be governed by the**  
7           **principles of risk and reward, rather than regulatory prescription or second-**  
8           **guessing. As I state in my Direct Testimony, the best mitigation incentive is for**  
9           **the utility to be at risk for a substantial portion of its strandable cost, and to be**  
10          **financially rewarded when its mitigation efforts are successful. This is**  
11          **accomplished by designing the transition charge to cover no more than 50 percent**  
12          **of strandable cost in a given year. Then, we can leave it to the utilities to**  
13          **implement whatever mitigation actions they believe to be most effective. This**  
14          **type of incentive mechanism relies upon the basic principles of the marketplace to**  
15          **guide utilities towards efficient mitigation strategies and represents a significant**  
16          **step in effecting a transition from a regulatory to a competitive paradigm for the**  
17          **utilities involved.**

18           **V. OTHER ISSUES**

19           **a. Special Contracts**

20   **Q.    Mr. Neidlinger (Navy) asserts that special contract customers should pay**  
21           **strandable cost charges. Would you comment on this?**

1 A. The Rule in its current form limits strandable cost charges to those  
2 customers participating in retail access. Special contract customers are not in that  
3 group. Therefore, they do not pay strandable cost charges under the Rule.

4 If strandable cost charges are extended to all standard offer customers,  
5 then the accompanying conditions I recommended in my Direct Testimony should  
6 also be adopted, namely: (1) The Standard Offer rate should be reduced by the  
7 amount of the transition charge, such that the final price for power paid by these  
8 customers is not increased, and (2) The Rule's existing treatment of self-  
9 generation, demand-side management, and other demand reductions unrelated to  
10 retail access should not be changed.

11 These essential provisions apply just as much to special contract  
12 customers as to standard tariff customers. If a strandable cost charge is levied on  
13 special contract customers, their special contract rate should be reduced by the  
14 amount of the transition charge, such that the final price for power paid by these  
15 customers is not increased. The determination of these charges should be made in  
16 accordance with the proportional cost allocation principle agreed upon by  
17 consensus of the Stranded Cost Working Group, and which I restate in my Direct  
18 Testimony [Higgins Direct, p. 30, lines 4-13]. Special contract customers are  
19 entitled to the same price cap provisions that are necessary for all customers  
20 generally. They should not be singled out to bear discriminatory cost increases  
21 under the guise of stranded cost recovery.

22 **b. Meter charges**

1 **Q. What is your opinion regarding the proposal by Dr. Block (Goldwater) and**  
2 **Mr. Lopezlira (Attny Gen) to use meter charges to collect strandable costs?**

3 **A.** Dr. Block and Mr. Lopezlira are correct when they assert that usage-based  
4 charges to collect strandable cost will introduce economic distortions.  
5 Unfortunately, the remedy they propose – meter charges based on historical usage  
6 – introduces a new set of implementation difficulties which may be more  
7 objectionable than the distortions they are intended to overcome. First, assigning  
8 future strandable cost charges based on past usage is likely to be administratively  
9 cumbersome, potentially requiring unique charges for each customer. Second,  
10 special difficulties arise in handling customers who change residences or business  
11 locations – and there will be many over the recovery period. Third, equity  
12 considerations arise in the case of customers who install energy conservation  
13 measures, or businesses which shut down part of their operations. Should such  
14 customers be saddled with strandable cost charges stemming from an earlier  
15 period's usage? I suggest not.

16 Collection of strandable costs through meter charges based on historical  
17 usage may resolve the problem of economic distortions introduced by usage-based  
18 charges. However, the new set of equity and administrative problems this  
19 approach would introduce suggests that this recovery mechanism should be  
20 avoided.

21 **c. Price caps**

22 **Q. Mr. Meek, Mr. Dabelstein, and Mr. Saline have raised questions over the**  
23 **appropriateness of a price cap. Do you wish to respond?**

1 A. Yes. These witness express concerns because they view price caps as  
2 requiring continued Commission regulation of generation prices. I wish to  
3 reiterate that a price cap is an essential component of recovery mechanism design.  
4 In my direct testimony, I explain that, in the context of stranded cost recovery, a  
5 price cap does *not* mean regulating the price of generation. Rather, it means  
6 designing the *transition charge* to accommodate the price cap objective. [Higgins  
7 Direct, pp. 33-35]. I should point out that, under this application of a price cap,  
8 the Commission is not intended to provide a blanket “insurance policy” for all  
9 customer transactions in the competitive market. Rather, the transition charge is  
10 designed to accommodate a price cap at the market price of power used for  
11 calculating strandable cost. Customers who strike retail access deals above the  
12 market-clearing price of power, may, in fact, see their individual prices go up.<sup>2</sup> On  
13 the average, however, a price cap is in force. Standard Offer customers – even if  
14 assigned strandable cost charges – are held harmless.

15 **d. Self-generation**

16 **Q. Mr. Dabelstein suggests that it might be desirable to levy exit fees on self-**  
17 **generators [Direct, pp.16-17]. Do you agree?**

18 A. No. I address this issue in my Direct Testimony (pp. 27-29) and  
19 previously-filed Rebuttal (pp. 11-12). In that testimony, I state that the current  
20 Rule treats self-generation (and demand-side management) appropriately by  
21 mandating that “any reduction in electricity purchases from an Affected Utility  
22 resulting from self-generation, demand side management, or other demand

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<sup>2</sup> Even this can be avoided, however, by using the true-up option I discuss on p. 33 of my Direct Testimony. Under this option, the utility receiving transition payments is required to offer generation to

1 reduction attributable to any cause other than the retail access provisions of this  
2 Article shall not be used to calculate or recover any Stranded Cost from a  
3 consumer.” [R14-2-1607(J)]

4 The reasoning behind this provision is correct. Options such as self-  
5 generation and demand-side management have been available to customers for  
6 many years. These demand reductions are business risks to the utility which pre-  
7 date retail access. Customers in the past have not been subject to stranded-cost-  
8 type penalties when exercising these options, and the advent of retail access  
9 should not to be used as a pretext to start insulating utilities from these ordinary  
10 business risks now. There should be no exit fees levied on self-generators, nor  
11 should the reduction in electricity purchases resulting from self-generation be  
12 penalized with stranded cost charges.

13 **e. Administrative and General (A&G) Costs**

14 **Q. Both Dr. Hieronymus (APS) and Dr. Rosen (RUCO) maintain that**  
15 **generation-related A&G costs should be included in strandable costs.**

16 **[Hieronymus Direct, p. 7; Rosen Direct, p. 61.] Do you agree?**

17 A. In general, no. A subtle, but important, distinction is necessary here. The  
18 net revenues lost approach uses projections of A&G costs in the *calculation* of  
19 strandable cost – but that is not the same as saying A&G costs are themselves  
20 strandable costs. Unlike fixed generation costs, such as long-term debt, A&G  
21 costs are “going-forward” costs, such as the president’s salary. In general, these  
22 costs are within the discretion of the utility, and should not be considered  
23 “strandable.”

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the payers at the price used to calculate strandable cost.

1           It is easiest to see this distinction by illustration. Assume a market retail  
2 generation price of 3.5 cents per kWh. Assume also that the utility has annual  
3 fixed generation costs of 2.5 cents per kWh, operating costs of 2 cents per kWh,  
4 and A&G costs (functionalized to generation) of 1 cent per kWh – resulting in  
5 total generation-related costs of 5.5 cents per kWh. Under the net revenues lost  
6 approach, strandable cost is 5.5 cents minus 3.5 cents, or 2 cents per kWh. Note  
7 that, in this example, the market price is covering all generation-related operating  
8 and A&G cost (3 cents together), plus a portion of fixed generation cost (.5 cent).  
9 “Stranded” cost is limited to the portion of fixed generation cost that is not  
10 recovered at the market price. A&G cost, while used in the calculation, is itself  
11 not a stranded cost.

12           Now assume a lower market price of 2.5 cents per kWh. The utility can  
13 cover all its operating costs and half of its A&G cost, but none of its fixed  
14 generation cost. Thus, all 2.5 cents per kWh of fixed generation costs are  
15 stranded. But what about the half cent of unrecovered A&G cost? Should this be  
16 added to stranded cost? I would argue not. The issue is not whether A&G costs  
17 are legitimate costs – it is whether it is legitimate to assign these discretionary  
18 costs to customers as strandable cost. It is one thing to make customers partly  
19 responsible for sunk, generation-related costs which were incurred under  
20 regulation. It is another matter to burden customers *who no longer take*  
21 *generation service* with the discretionary A&G costs that are “assigned” to  
22 generation. These costs (plus generation-related operating costs) should be  
23 recoverable only from the competitive market. If the utility is unable to do so, it

1           should absorb the unrecovered portion without recourse to strandable cost

2           charges.

3   **Q.    Does this conclude your rebuttal testimony?**

4   **A.            Yes, it does.**

5