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

DOCKET NO. RE-00000C-94-0165

NOTICE OF FILING

Citizens Utilities Company hereby provides Notice of Filing the Rebuttal Testimony of Sean Breen as required by the Commission's Order in the above-referenced docket.

RESPECTFULLY SUBMITTED this 4th day of February, 1998.

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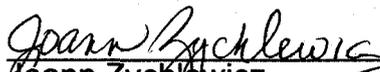
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## SUMMARY OF REBUTTAL TESTIMONY

Mr. Breen's rebuttal testimony presents the response of Citizens Utilities Company ("Citizens") to various arguments set forth by the parties concerning the level of stranded cost recovery and market valuation of stranded costs. Mr. Breen's rebuttal testimony demonstrates that:

1. Regulatory policy does not support denial of costs stranded by industry restructuring. In fact it would be bad policy if regulators failed to honor past regulatory commitments;
2. There is no evidence that shareholders have been compensated for the risk of denial of stranded cost recovery. Risk premiums have not included compensation for the risk of regulators reversing past decisions on cost recovery; and
3. Stranded cost recovery need not create adverse market impacts if the proper method is selected to value stranded costs and the appropriate recovery methodology is chosen.

Finally, Mr. Breen's rebuttal testimony urges the Commission to allow sale of generation assets and contracts, under guidelines it dictates, as one acceptable means for stranded cost valuation.

Rebuttal Testimony of Sean R. Breen  
Citizens Utilities Company, AED  
Stranded Cost Procedural Order  
Docket RE-00000C-94-0165

1 Q. Please state your name and position.

2 A. My name is Sean R. Breen. I am the Director of Energy Services for Citizens  
3 Utilities Company.

4

5 Q. Are you the same Sean R. Breen who submitted direct testimony in this  
6 proceeding?

7 A. Yes, I am.

8

9 Q. What is the purpose of your rebuttal testimony?

10 A. The purpose of my rebuttal testimony is to respond to two key issues concerning  
11 stranded costs raised by the various parties to this case: the level of recovery and  
12 the method of valuation.

13

14 Q. Does the limitation of your rebuttal to these matters mean that you have no opinion  
15 on or no objection to other positions taken or issues raised by the parties to this  
16 case.

17 A. No. I am limiting my rebuttal to focus the debate on those areas which are of  
18 greatest importance to Citizens.

19

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Rebuttal Testimony of Sean R. Breen  
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1 Q. Regarding the first issue, are you persuaded by the testimony of the other parties to  
2 this case that utilities should be limited to something less than full recovery of  
3 stranded costs?

4 A. No, I am not, nor should the Commission be. None of the reasons cited for less  
5 than full recovery of stranded costs is valid.

6

7 Q. What reasons were cited for less than full recovery?

8 A. Several witnesses assert that shareholders should bear all or a portion of the costs  
9 stranded by the re-regulation of the industry. Their arguments generally fall into  
10 three key areas: Regulatory Policy; Shareholder Risk and Responsibility; and  
11 Market Impacts. I will address each of these areas in my rebuttal testimony.  
12 Before doing so, I make one over-arching observation. Several parties to this case  
13 have set forth long and elaborate arguments for having shareholders shoulder the  
14 cost for changing the rules of regulation, however none of these come close to  
15 justifying the unavoidable truth in this matter: denial of stranded cost recovery is no  
16 different than defaulting on a contract.

17

18

19

20

1 Q. What do you mean by "stranded costs?"

2 A. By "stranded costs," I mean net stranded costs after mitigation. As I stated in my  
3 direct testimony, Citizens agrees that Affected Utilities should be required to  
4 vigorously pursue reasonable means to mitigate any costs stranded by industry re-  
5 gulation.

6  
7 Q. Referring to the first argument based on Regulatory Policy, what are the specific  
8 reasons cited for less-than full recovery of stranded costs?

9 A. The Regulatory Policy arguments generally assert that the precepts of utility  
10 regulation allow denial of the costs stranded by industry restructuring. I would  
11 paraphrase the Regulatory Policy arguments as follows:

12 Deregulation of generation is being driven by technological  
13 change, not regulatory change. In any case, there never was a  
14 regulatory compact that guaranteed 100% recovery and sharing  
15 stranded costs strikes a reasonable balance between the  
16 interests of customers and investors. Besides, regulation is  
17 intended to emulate competition, so theoretically, stranded  
18 recovery should be zero.

19  
20 Q. Are any of these compelling arguments?

21 A. No, none of them would begin to justify the *de facto* confiscation of utility property  
22 represented by denial of stranded cost recovery.

23

1 Q. Regarding the Regulatory Compact, are you saying that, in fact, utilities are  
2 guaranteed 100% cost recovery?

3 A. No. Clearly, regulators here in Arizona and across the country have disallowed  
4 expenses and investments that were judged imprudent or not used and useful.  
5 However, it would be a completely different matter for an investment or expense  
6 that has passed the prudence standard after regulatory review to be later denied  
7 recovery due to changes in regulation.

8  
9 Q. Why would later denial of recovery be a "completely different matter?"

10 A. Denial after approval would be tantamount to defaulting on a contract. Through the  
11 regulatory framework in place, regulators have in effect made promises to induce  
12 investments. In exchange for these promises, utilities have made investments to  
13 fulfill their public service obligations. Denying recovery now would breach the  
14 contract between the regulators and the utilities.

15  
16 Q. Is industry re-regulation driven by technological change rather than regulatory  
17 change?

18 A. It may be the case that technological change is an important driving force behind  
19 industry restructuring, but changes in technology have never required regulators to  
20 renege on past commitments. No measure of fairness could justify failing to honor

1 past commitments made by regulators simply because events unfolded differently  
2 than they at one time believed.

3  
4 Q. Are the potential savings available to electric users sufficient justification for  
5 *reneging on commitments made to utility companies?*

6 A. No. Reneging on past commitments by government is wrong for at least two key  
7 reasons. While I am not a lawyer and will not cite cases, it seems obvious that it  
8 would be illegal for government to in effect confiscate money from investors.  
9 Second, denial of stranded cost recovery would undermine the credibility of  
10 government. Without credible government, the citizens of Arizona would suffer  
11 because the cost of funding government-sponsored projects would increase and  
12 the ability to encourage long-term investment in the State would be seriously set  
13 back.

14  
15 Q. Referring to the second alleged basis for stranded-cost disallowance, Shareholder  
16 Risk and Responsibility, what are the reasons cited for less than full recovery of  
17 stranded costs?

18 A. The Shareholder Risk and Responsibility argument asserts that denial of stranded  
19 recovery is justified because change in regulation is a risk that investors should

1 bear. I would paraphrase the Shareholder Risk and Responsibility argument as  
2 follows:

3 Utility shareholders have known for years that deregulation was  
4 coming and could have sold their stock. Investors have already  
5 been compensated for the risks of changed regulation through  
6 the risk premiums they've earned over the years. Besides,  
7 utilities managers have manipulated the system to their  
8 advantage and been among the most successful American  
9 businesses as a result. If any stranded cost recovery is  
10 granted, it should be only enough to just maintain their financial  
11 viability, because any more than that would weaken the  
12 incentives for mitigation.  
13  
14

15 Q. Are these compelling reasons for denying full stranded cost recovery?

16 A. No, absolutely not.

17  
18 Q. Isn't it true that shareholders have known competition was coming for years and  
19 could have sold their stock?

20 A. Perhaps, but this is beside the point. Shareholders had no reason to believe that  
21 regulators would renege on their commitment to allow utilities a reasonable  
22 opportunity to earn a reasonable return on and of their prudent investments. If the  
23 risk of regulatory reversal of this commitment was actually perceived as a real risk  
24 by the investment community, I suspect that the cost of capital to utilities would in  
25 fact have skyrocketed over the last several years. This has not happened because

1 investors have implicitly assumed regulators would honor their long-standing  
2 commitments.

3  
4 Q. But isn't it true that utility investors have been compensated for the risk that a  
5 change in regulation could render their investments unrecoverable?

6 A. No. I am not a cost-of-capital expert, but I think some common sense should  
7 prevail here. Several parties have pointed out that utility investment is not risk free.  
8 This is true – investors are subject to the prudence and used-and-useful standards  
9 and are given only the *opportunity* to recover their investments (business risk).  
10 However, it is also true that on the continuum of investment returns demanded by  
11 the marketplace, utilities fall on the lower end of the scale. Given this  
12 understanding, it strains credulity to suggest that the utilities' moderate premium  
13 above a risk-free return has included the risk that regulators could reverse past  
14 decisions on cost recovery and flip the industry on its head. Indeed, if the common  
15 expectation was that utility investment would be subject to sweeping regulatory  
16 changes that could render significant portions of its assets uneconomic, the  
17 industry we have today, with its relatively low cost of capital, would not exist.

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1 Q. To this point you have largely discussed investments. What about full recovery for  
2 stranded purchased power costs?

3 A. Disallowing purchased power costs would be even more unconscionable. Citizens'  
4 purchase power costs have been passed directly to customers - without profit or  
5 markup - through a Purchased Power and Fuel Adjustment Clause ("PPFAC") in  
6 Citizens' rates. These costs were previously examined and approved by the  
7 Commission. No one can argue that Citizens' shareholders have already been  
8 compensated through a risk premium in the cost of capital.

9  
10 Q. It is true that American utilities are among the most successful companies in the  
11 world?

12 A. I don't know this for a fact, but I trust the Goldwater Institute witnesses, who  
13 reported this in their testimony, are reporting their findings factually.

14  
15 Q. Do you agree, as the Goldwater Institute witnesses have stated, that since utilities  
16 have had the chance to earn profits that rival those of the most successful  
17 unregulated firms, it does not make sense to protect them from losses like those  
18 faced by unregulated firms?

19 A. Overall, I find their reasoning lacks credibility. First, the losses represented by the  
20 denial of stranded cost recovery are extraordinary and not "like those faced by

1 unregulated firms.” As the Goldwater Institute points out in its own testimony,  
2 unregulated firms were never saddled with public service obligations that required  
3 investment to meet the publics’ needs. Unregulated firms could enter or exit a  
4 market at will. Further, unregulated firms could hit a home-run and reap enormous  
5 profits – regulated firms shouldered earnings caps. One would gather from its  
6 testimony that the Goldwater Institute regards stranded costs as little more than ill-  
7 gotten gains by utilities for which they now must make amends. In fact, any  
8 savings to consumers resulting from disallowance of costs previously approved by  
9 regulators would not be a gain, but a transfer of wealth from investors to consumers  
10 – a transfer made possible by repudiation of prior commitments.

11  
12 Q. Should the Commission deny full recovery of stranded costs to motivate utilities to  
13 mitigate?

14 A. No. While holding utilities accountable for taking reasonable steps to mitigate their  
15 strandable costs is proper, restricting recovery based on a projection of what level  
16 of mitigation should be achievable is arbitrary. The mitigation review process is  
17 indeed a large “stick” for motivating vigorous pursuit of mitigation strategies. If the  
18 Commission finds that this “stick” is not sufficient motivation, a “carrot” would be a  
19 better alternative to a bigger “stick.” An incentive, for instance in the form of the  
20 ability to share a fraction of stranded costs successfully mitigated, would inspire far

1 more innovation than would result from the inevitable defensive scramble and time-  
2 consuming contentious proceedings created by the threat of severe penalty.

3  
4 Q. Turning now to the third alleged reason for disallowing stranded costs, Market  
5 Impacts, what are the reasons cited for less-than full recovery of costs stranded by  
6 the re-regulation of the industry?

7 A. The area of Market Impacts includes the arguments that stranded cost recovery  
8 would discourage business expansion, distort the price of power, and allow utilities  
9 to compete unfairly. The most heated issue appears to be the latter – that allowing  
10 utilities to recover stranded costs will provide them unfair competitive advantage  
11 and increase market power.

12  
13 Q. Does stranded cost recovery interfere with the working of the competitive market?

14 A. I would agree that this is a potential problem, but one that is easily avoidable.  
15 Under Citizens' approach, where stranded recovery is allowed for those utilities that  
16 voluntarily divest their generation assets, the issue of market interference becomes  
17 moot. Stranded cost would be determined by the difference between the book  
18 value of assets and the prices garnered in the auction. Recovery of stranded costs  
19 would be through a fixed monthly charge (based on historical usage) on the bills of

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1 the local distribution company. No accounting manipulation would be possible to,  
2 for instance, subsidize competitive operations, nor could the price of power be  
3 distorted; power suppliers would compete head-to-head on price.  
4

5 Q. Turning now to the area of valuation of stranded costs, has there been any  
6 consensus on the method of calculation?

7 A. No, although the administrative approach of net lost revenues and the market  
8 approach of asset auction seem to be the leading alternatives based on filed  
9 testimony. Several parties who are not Affected Utilities favored the asset auction,  
10 while the largest Affected Utilities, Arizona Public Service ("APS") and Tucson  
11 Electric Power ("TEP") favored net lost revenues. However, Mr. Bayless of TEP  
12 described asset auction as the "only feasible approach" of the other alternatives  
13 and suggested that this alternative remain an option, whatever method is selected.  
14

15 Q. Did any of the parties discuss drawbacks of the asset auction approach?

16 A. Yes. A number of the parties raised concerns about asset sales, most of which  
17 were addressed in my direct testimony. Citizens recognizes that no valuation  
18 approach is without drawback, but continues to believe, for the reasons set forth in  
19 my direct testimony, that, particularly at this early stage of the national movement  
20 toward industry restructuring, market valuation through asset sale, is the best

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1 course for Arizona to take. At a minimum, Citizens urges the Commission to allow  
2 sale of generation assets or contracts, under guidelines it dictates, as one  
3 acceptable means for stranded cost valuation.

4

5 Q. Does this conclude your rebuttal testimony?

6 A. Yes, it does.

7

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