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BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN  
COMMISSIONER-CHAIRMAN  
RENZ D. JENNINGS  
COMMISSIONER  
CARL J. KUNASEK  
COMMISSIONER

DOCKET NO. U-0000-94-165

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

NOTICE OF FILING OF REBUTTAL  
TESTIMONY OF DOUGLAS C.  
NELSON AND SUBSTITUTION OF  
ENRON CONTACT PERSON

NOTICE is given that the Electric Competition Coalition (ECC) has filed the rebuttal testimony of Douglas C. Nelson.

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RESPECTFULLY submitted this 7<sup>th</sup> day of February, 1998.

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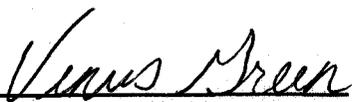
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**BEFORE THE ARIZONA CORPORATION COMMISSION**

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

DOCKET NO. U-0000-94-165

REBUTTAL TESTIMONY OF DOUGLAS C. NELSON, PH.D.  
ON BEHALF OF  
ELECTRIC COMPETITION COALITION

FEBRUARY 4, 1998

1                   **Summary of the Rebuttal Testimony of Douglas C. Nelson, Ph.D.**  
2                   **on Behalf of Electric Competition Coalition**

3                   **Docket No. U-0000-94-165**

4                   **The "rolling" stranded cost method proposed by the Arizona Public Service Company**  
5 **would be anticompetitive and discourage the mitigation of stranded costs.**

6                   **The Federal Energy Regulatory Commission, in its Order 888, has adopted the "revenues**  
7 **lost" approach which grants wholesale customers the option of marketing the excess generation**  
8 **that may result if that customer departs from the utility. FERC requires that these stranded costs**  
9 **be determined upfront and be fixed. Furthermore, FERC grants the customer the ability to**  
10 **select the method of payment. The Net Revenue Lost approach, as proposed by some in this**  
11 **proceeding, does not include the market-based principles which were adopted in the FERC**  
12 **approach. As a consequence, I support the divestiture of generation assets so that both retail**  
13 **and wholesale customers may rely on the market-based value of any strandable excess**  
14 **generation.**

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REBUTTAL TESTIMONY OF DOUGLAS C. NELSON, PH.D.  
ON BEHALF OF  
ELECTRIC COMPETITION COALITION

FEBRUARY 4, 1998

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1  
2 Q. What is the nature of your rebuttal testimony?

3 A. Some of my rebuttal testimony was presented in my January 15, 1998 testimony, which  
4 was filed on January 21, 1998. For instance, I discussed the shortcomings of using the  
5 Dow Jones Palo Verde Index or the California Power Exchange as indicators of market  
6 price at page 4. In addition, I raised concerns about the failed "regulatory compact"  
7 theory in Arizona and how it relates to the Net Revenue Lost approach, at pages 8 and  
8 9.

6 Q. Do you have additional rebuttal testimony?

7 A. Yes, although I will limit my response to some very specific issues. First, I would like  
8 to address the "rolling" calculation of stranded costs as proposed by Arizona Public  
9 Service Company (APS). Testimony of Jack E. Davis (January 9, 1998) at 8-11.  
10 Second, I wish to comment on why the Federal Energy Regulatory Commission (FERC)  
11 may have used a variation of the net revenue approach but that method should not be  
12 applied to retail generation facilities. Testimony of William H. Hieronymous (January  
13 9, 1998) at 14.

#### 11 The APS "Rolling" Stranded Cost Method

12 Q. Please explain your concerns about using the "rolling" stranded cost recovery approach  
13 suggested by the Arizona Public Service Company.

14 A. The APS methodology would greatly discourage and perhaps foreclose the competitive  
15 sale of generation. Consumers and competitors would not know what the future stranded  
16 costs obligation might be. Therefore, consumers are likely to take a "wait and see"  
17 attitude and stay with the utility's standard offer. Competitors would be unable to offer  
18 a fixed total electric price to consumers, because APS would be controlling the stranded  
19 cost component. Customers will be further confused because they will not know if they  
20 can return to the standard offer if it might be less than the combined competitive-  
21 generation and stranded cost component.

22 To further complicate this situation, APS has been silent on how it would unbundle its  
23 transmission, generation, distribution, and ancillary services. Competitors and  
24 consumers will know how much generation will cost, but they won't know what the other  
25 unbundled rates or the "rolling" stranded cost might be. Consumers will be unable to  
26 make "apple to apple" comparisons; new entrants will be unable to set a "market" price;  
27 and the utilities might falsely claim customers are satisfied because they didn't change  
suppliers.

Another major problem with the APS approach is that it does not create an incentive for  
APS to manage its stranded costs. All consumers, both those that stay with APS  
generation and those that buy from others, will likely pay more for stranded costs under  
the APS approach, as compared to any market-based approach.

25 Q. You mentioned that a relatively precise stranded cost figure is needed in order for  
26 competition to occur. Have the utilities been able to provide a relatively precise estimate  
27 of stranded costs using future market value models?

1  
2 A. Generally no. The utilities hire consultants who use different models and formulae in  
3 an effort to forecast the future market value of generation. For example, PECO Energy  
4 estimated its future value of its generation in a competitive environment ranging from  
5 \$1.865 billion to \$3.65 billion, using three witnesses and a variety of methods and  
6 assumptions. Application of PECO Energy for Approval of its Restructuring Plan under  
7 Section 2806 of the Public Utility Code and Joint Petition for Partial Settlement, Docket  
8 Nos. R-00973953/P-00971265, Pennsylvania Public Utility Commission (December 11,  
9 1997) at 44-48.

6 The PECO Energy experience illustrates how difficult it is to forecast the future market  
7 value of generation without divestiture.

### 8 **Comparison of FERC's Revenues Lost Method to the Proposed Net Revenue Lost Approach**

9 Q. You mentioned the FERC Order 888 and that FERC's "revenues lost" approach would  
10 not be an appropriate method to use in addressing stranded cost while restructuring the  
11 retail electric industry. Please explain.

11 A. The Federal Energy Regulatory Commission focused on individual wholesale  
12 requirements contracts dealing with specific transmission owners and generation facilities  
13 in adopting Order 888.<sup>1</sup> These contracts pertain to specific facilities and lines which  
14 allow for the clear identification of rates (or prices). Recovery of wholesale stranded  
15 costs from departing customers is by direct assignment. Individual cost-based pricing  
16 of each facility lends itself to a precise calculation of the rate before competition as  
17 compared to the price after open access.

15 These circumstances are far different from a situation where a utility has numerous  
16 facilities with vertically integrated transmission, generation, distribution, and ancillary  
17 services. The Net Revenue Lost approach, as suggested in this proceeding, cannot track  
18 the individual contract (customer tariff) or facility cost-component rate as compared to  
19 the wholesale experience under FERC Order 888.

18 Another important distinction is that the strandable costs associated with wholesale  
19 generation and transmission are relatively minor when compared to retail generation.  
20 The margin of error in over or under collection of stranded costs is much less when  
21 using the revenues lost approach in the wholesale industry, as compared to the Net  
22 Revenue Lost approach for a vertically integrated utility in the retail industry.

21 Q. What would you consider to be the key differences between FERC's revenues lost  
22 approach and the Net Revenue Lost approach being proposed by some in this proceeding?  
23

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24 <sup>1</sup> See Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission  
25 Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting  
26 Utilities, Order No. 888, 61 Fed. Reg. 21,540 (1996), FERC Stats. & Regs. 31,036 (1996), order  
27 on reh'g, Order No. 888-A, 62 Fed. Reg. 12,274 (1997), FERC Stats. & Regs. 31,048 (1997),  
order on reh'g, Order No. 888-B, 81 FERC 61,248 (1997).

1  
2 A. The names sound similar but the formulae and conditions are different. There are at  
3 least three important distinctions between FERC's revenues lost approach and the Net  
Revenue Lost approach suggested by some here.

4 First, the customer has the opportunity to buy the strandable generation, under FERC  
5 Order 888. Excess generation (and associated energy) may occur when the customer  
6 leaves the utility. The utility is required to identify the amount of system capacity (and  
7 associated energy) that will be released by the departing customer and used in its revenue  
8 lost calculation. The departing customer has a choice, to market the released capacity  
(and associated energy) and receive an asset for his or her stranded payment. That  
market condition assures the customer that the utility will not place an unreasonably low  
market value on that excess capacity and associated energy.

9 Second, the stranded cost values are determined upfront and are fixed. This allows the  
10 customer the opportunity to budget and plan. Competitors have defined parameters for  
marketing generation. Utilities have incentives to mitigate those fixed stranded costs.

11 Third, the customer may choose the method of payment, such as by lump-sum or  
12 periodic payments, or perhaps through a transmission wires charge. This allows the  
13 customer to tailor the payment plan to his or her cash flow requirements. These  
conditions are substantial different from the notion of the Net Revenue Lost approach  
which is being talked about in this proceeding.

14 Q. How does FERC protect the wholesale consumer and competitors?

15 A. Generation capacity is freed up when a customer departs. The recovery of stranded cost  
16 will subsidize the fixed cost of that capacity, allowing the utility to remarket that capacity  
17 at artificially low prices in other jurisdictions. Both the captive customers and  
18 competitors of the utility are disadvantaged when "the customer pays" and "the utility  
owns" the stranded asset. FERC grants the consumer and competitors some protection  
by allowing the consumer to market the excess generation if the customer believes the  
utility's estimate of market values are too low.

19 Q. What would the Corporation Commission have to do if it applied FERC's revenues lost  
approach?

20 A. In applying FERC's revenues lost approach, the Corporation Commission would have  
to implement these steps for each departing customer:

- 21 1. The utility must offer proof of the time period the utility could have reasonably  
22 expected to serve the departing customer, which is different from the useful life  
23 or amortization period of the utility's generation facilities.
- 24 2. The utility would identify the amount of released capacity (and associated energy)  
that will be freed up as a result of the customer's leaving the utility.
- 25 3. The average amount paid by the customer over the past 3 years for generation  
26 services would be calculated.
- 27

1  
2 4. The utility would estimate the average annual revenue that it would have received  
3 from the released capacity and energy, using the future period when it could have  
reasonably expected to serve that customer.

4 5. The customer would provide the actual average annual cost of that replacement  
5 capacity and energy. The customer would then have the option of using its  
6 replacement cost or the utility's estimate (described in step 4) to figure the  
stranded cost.

7 These 5 steps are dramatically different from the Net Revenue Lost approach suggested  
8 by some in this proceeding. First, all revenue changes, not just those relating to  
9 generation and the departing customer, would be recovered under the Net Revenue Lost  
10 approach. Second, the utility would not have to identify which generation asset might  
11 become stranded. Third, the retail customer does not have the option of using the  
12 utility's estimate of future revenue from released power or its own replacement cost.  
13 Fourth, the FERC "reasonable expectation period" for recovering stranded cost is the  
duration of wholesale contractual commitment; not necessarily the entire life of the asset,  
as proposed in the Net Revenue Lost approach. Further, the utility would have to show  
the reasonable expectation of serving the particular customer who decided to depart.  
This may be difficult, especially for those customers that received special discount  
contracts in the past, those that thought about self-generation, those that engaged in  
significant demand-side management, and those that considered creating their own  
municipal utility.

14 Q. May the FERC revenues lost approach be applied on the retail level?

15 A. It would be extremely difficult. An individual residential customer or even a group of  
16 customers may not have the resources to exercise the purchase option the utility may set  
17 for the market value of its excess generation. In keeping with the FERC market-based  
18 principles, I support the divestiture of generation assets so that collectively all of the  
utility customers would benefit from the exercise of that market option. This market  
driven approach, under the supervision of the Corporation Commission, would benefit  
all consumers and not just those that have the ability to purchase at wholesale.

19 Q. Does this conclude your rebuttal testimony?

20 A. Yes.

21  
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