BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
Commissioner-Chairman
RENZ D. JENNINGS
Commissioner
CARL J. KUNASEK
Commissioner

IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.	DOCKET No. RE-00000C-94-0165

ARIZONANS FOR ELECTRIC CHOICE AND COMPETITION, ASARCO INCORPORATED, AND CYPRUS CLIMAX METALS COMPANY'S INITIAL BRIEF REGARDING RECOVERY OF STRANDED COSTS

March 16, 1998

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TABLE OF CONTENTS

SUMMARY OF ELEVEN ISSUES

ISSUE 1: SHOULD THE ELECTRIC COMPETITION RULES BE MODIFIED?

The Rules generally provide a workable framework for addressing stranded cost recovery. AECC believes that the Rules need only minor supplementation and clarification regarding allocation of stranded costs and the filing deadlines. See Exhibit A.

ISSUE 2: WHEN SHOULD THE AFFECTED UTILITIES BE REQUIRED TO MAKE A STRANDED COST FILING PURSUANT TO A.C.C. R14-2-1607?

AECC recommends that the Affected Utilities be required to file requests for recovery of stranded costs no less than eight months before they desire to begin collecting a Commission approved charge from customers.

ISSUE 3: WHAT COSTS SHOULD BE INCLUDED AS PART OF STRANDED COSTS AND HOW SHOULD THEY BE CALCULATED?

Stranded cost recovery should include a portion, between 25 and 50 percent, of an Affected Utility's Commission-approved generation-related fixed costs plus regulatory assets actually exposed to competition. Operating costs should not be included in stranded costs.

Stranded costs should be calculated using the replacement cost valuation approach whereby stranded costs are estimated on an asset-by-asset basis taking the difference between net book value and current replacement cost. In the alternative, stranded costs should be determined using a hybrid of the replacement cost valuation combined with a net lost revenue approach if the Commission were to designate a limited transition period of 3-5 years. The net lost revenue approach would be used to estimate year-to-year stranded costs. The replacement cost would provide an upper limit on the total stranded costs over the transition period.

ISSUE 3a: WHAT IS THE APPROPRIATE TREATMENT OF MARKET PRICE?

The appropriate treatment of market price should involve use of the retail price. This retail price will include a mark-up of the underlying wholesale price which will be a blend of the spot market and long-term prices.

ISSUE 3b: WHAT ARE THE IMPLICATIONS OF FAS 71?

The implications of FAS 71 are dependent on numerous factors, including the magnitude of stranded costs identified, the ameliorating effects of the phase-in, and the extent to which the utility anticipates it can successfully mitigate its stranded costs. In any event, accounting rules should not drive regulatory policy.

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ISSUE 4: SHOULD THERE BE A LIMITATION ON THE TIME FRAME OVER WHICH STRANDED COSTS ARE CALCULATED?

This issue presumes that stranded costs will be calculated using annual data. It is AECC's position that a method that provides a total stranded cost estimate at the outset, such as replacement cost valuation, is preferred. However, if stranded costs are calculated using annual data, then the period subject to that calculation must be limited to no more than 3-5 years.

ISSUE 5: SHOULD THERE BE A LIMITATION ON THE RECOVERY TIME FRAME FOR STRANDED COSTS?

Yes. The transition period during which stranded costs can be recovered must be limited to 3-5 years.

ISSUE 6: WHO SHOULD PAY FOR STRANDED COSTS AND WHO, IF ANYONE, SHOULD BE EXCLUDED?

Transition charges for stranded costs may only be levied on purchases made in the competitive marketplace. Those not participating in competition will pay for stranded costs in their standard offer and special contract rates, respectively. The current rules indicate that no stranded cost changes are assigned to the reduction in energy purchasing associated with self-generation or demand-side management. This provision of the rules should be retained. Similarly, interruptible customers should not pay stranded costs as there are no stranded costs associated with interruptible service. Stranded costs should be allocated in a manner consistent with the specific Affected Utilities' current rate treatment of the stranded asset.

ISSUE 7: SHOULD THERE BE A TRUE-UP MECHANISM?

A "true-up" is not necessary if the recovery mechanism incorporates an equitable and efficient sharing of responsibility for stranded cost recovery. A true-up is only necessary to correct for deviations in expected market price, particularly if the net revenues lost approach is used.

ISSUE 8: SHOULD THERE BE A PRICE CAP OR RATE FREEZE?

Price caps are an essential component of a stranded cost recovery program. The objective of a price cap can be met by determining stranded costs on a year-to-year basis and requiring customers to pay only for stranded costs associated with that year. A price cap means that for any customer the sum of the transition charges plus delivery charges plus the market price of generation does not exceed the current rates for the customer. AECC does not support a price freeze.

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ISSUE 9: WHAT FACTORS SHOULD BE CONSIDERED FOR MITIGATION?

The best mitigation incentive is for the utility to be at risk for a substantial portion of its stranded costs, and to be financially rewarded when its mitigation efforts are successful. This is accomplished by designing the transition charge to cover no more than 50 percent of stranded costs in a given year. Thus, the utilities are left to implement whatever mitigation actions they believe to be most effective.

I. Introduction.

Pursuant to the Commission's March 3, 1998 Procedural Order, Arizonans for Electric Choice and Competition,[1] ASARCO Incorporated and Cyprus Climax Metals Company (collectively referred to herein as "AECC"), hereby submit their Initial Brief regarding the eleven issues identified in the Hearing Division's December 1, 1997 Procedural Order pertaining to stranded cost recovery.[2]

This brief sets forth: (i) AECC's position regarding each of the eleven issues identified by the Hearing Division for comment and (ii) the legal and equitable bases underlying its position with respect to the issue of a regulatory contract.

II. The Eleven Stranded Cost Issues.

A. Prefatory Comment Regarding Sharing of Responsibility for Stranded Costs.

The assignment of responsibility to customers for recovery of any potentially stranded costs is an extraordinary proposition, for it involves the use of a special surcharge to compensate private companies for uneconomic costs. The recovery of these uneconomic costs is placed at risk by virtue of the impending change in market structure from regulated monopoly to

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[1] 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.

[2] Actually, the December 1, 1997 Procedural Order identifies nine issues and the December 11, 1997 First Amended Procedural Order identifies two additional issues.

competition. Regulatory change is a business risk inherent in all industries and, generally, is borne by company shareholders. However, because the electric utility industry has been regulated, the Affected Utilities[3] maintain that stranded cost recovery is the sole responsibility of customers. Their argument presumes that deregulation of generation service is a one-way street: good for consumers, bad for investors. It ignores the fact that deregulation of generation prices will mean that investors will have the opportunity over the long-run to earn above a regulated return - using the very assets that will be the subject of stranded cost claims.

Investors in electric utilities have been on notice of the advent of restructuring and regulatory changes that would introduce greater competition for a number of years. Although these changes might place the recovery of some fixed costs at risk, at least in the short-term, they will provide long-term opportunities for most, if not all, of the Affected Utilities. Thus, because competition will provide opportunities for both customers and investors, it is inappropriate to conclude that changing the regulatory paradigm requires customers alone to shoulder the risk of stranded costs.

In the Electric Competition Rules (the "Rules"), the Commission recognizes its obligation to strike an appropriate balance between customer and utility interests by enumerating factors it will consider in determining stranded cost recovery. Included in these factors are: the impact of stranded cost

[3] Use of the term "Affected Utilities" in this brief does not include Morenci Water and Electric Company or Ajo Improvement Company.

recovery on prices paid by consumers in the competitive market, the impact on customers who do not participate in the competitive market, the impact (if any) on the Affected Utility's ability to meet debt obligations, and the impact of stranded cost recovery on the effectiveness of competition itself. It is clear from these factors that the Commission seeks to balance customer and utility interests in approving a stranded cost recovery mechanism.

To achieve this balance, the recovery mechanism should be designed to ensure recovery of some reasonable portion of stranded costs via a transition charge paid by customers, while leaving the utilities with the opportunity to capture the remaining portion of stranded costs through mitigation efforts. The portion to be recovered through mitigation should be deemed "at-risk" for the utility from the outset; it should not be assigned at any time to the customers' transition charges.

Deeming a pre-determined portion of stranded costs to be at-risk to the utility is not arbitrary and capricious, as suggested by the Affected Utilities. To the contrary, determining up-front the portion to be placed at risk is essential for establishing appropriate incentives for mitigation efforts. The portion to be deemed at-risk should be determined by considering the factors enumerated in the Rule. A number of witnesses have offered policy guidance on the appropriate portion of potential stranded costs that should be recovered through a transition charge to customers. AECC asserts that the portion of stranded costs to be recovered through the transition charge should be in the range of 25 to 50 percent. This recommendation

is the appropriate point of departure for assigning responsibility for uneconomic costs during the transition period between monopoly regulation and completely open competition in generation. The location within the range should even be lower if the calculation methodology is relatively generous to the Affected Utilities. It should also be lower in recognition of the potential hazard of overemphasizing short-term market conditions to the detriment of consumers under the net revenues lost approach.

B. Issue 1: Should the Electric Competition Rules Be Modified?

Fundamentally, the Rules do not need to be modified. The Rules provide a workable definition of stranded costs and anticipate that recovery of a utility's stranded costs will be addressed through evidentiary hearings. Moreover, the Rules provide important guidance by identifying the factors the Commission must consider in designing a stranded cost recovery program.

Notwithstanding the above, AECC proposes adding supplemental and clarifying provisions to the Rules concerning: (1) utility filing deadlines, (2) allocation of stranded costs among customers, and (3) reinforcement of the Commission's intention to balance utility and customer interests. These suggested supplemental provisions are set forth in the attached Exhibit "A."

C. Issue 2: When Should Affected Utilities Be Required to Make a Stranded Cost Filing Pursuant to A.C.C. R14-2-1607?

A stranded cost filing is only necessary when an

Affected Utility seeks to recover its stranded costs from customers through a Commission approved charge. In that event, the utility bears the burden of preparing and filing such request far enough in advance of the date it wishes to initiate recovery to allow for evidentiary hearings. AECC recommends that the utilities be required to file requests for recovery of stranded costs no less than eight months before they desire to begin collecting a Commission approved charge from customers.

Even more importantly, the implementation of retail competition should not be delayed because individual Affected Utilities' stranded cost issues remain unresolved by January 1, 1999. Affected Utilities have been on notice since 1996 that retail access would commence January 1, 1999. If an Affected Utility does not take sufficient steps to address its concerns regarding stranded costs in time to effect recovery commencing January 1, 1999, then recovery, and not retail competition, should be delayed until such steps are taken.

D. Issue 3: What Costs Should Be Included as Part of Stranded Costs and How Should They Be Calculated?

1. What Costs Should Be Included as Part of Stranded Costs?

"Stranded costs" is a term used to refer to that portion of a utility's regulator-approved, generation-related fixed costs and regulatory assets which the utility does not recover due to the introduction of a competitive generation market and the resultant lower electricity prices. The Rules define stranded costs in an equivalent manner: the net difference between the value of a utility's generation-related assets and obligations under traditional regulation and the market value of

those assets and obligations directly attributable to the introduction of competition. As such, stranded costs is not an enumeration of costs *per se*, but the difference between these two valuations.

Stranded costs do not include any operating costs. If a facility's operating costs cannot be recovered in a competitive market, economic rationality dictates that the facility be shut down. The exception to the shut-down rule would occur only in the case of a facility required to operate for reliability-related reasons. Such facilities require special pricing and operating treatment under retail competition.

It follows then, that the only costs that should be included as part of stranded costs is some portion of the Commission-approved, generation-related fixed costs and regulatory assets. The only portion of a utility's fixed costs that have the potential to be "stranded" is the portion exposed to competition. Consequently, under the proposed Rules, only twenty percent of a utility's retail generation business has any stranded cost exposure for the first two years of retail access. In subsequent years, the utilities' stranded cost exposure must be proportionate to their share of the retail market which is open to competition pursuant to the Rules' phase-in-provision.

2. How Should Stranded Costs Be Calculated?

a. Auction and Divestiture.

Auction and divestiture is conceptually the best method for determining overall stranded costs because it is the most direct means of evaluation. Using this method, stranded costs are computed by taking the difference between the net book value

of generation assets (plus regulatory assets) and the proceeds from the sale of these generation assets at auction. Auction and divestiture has two distinct advantages. First, by using a market transaction to value generation assets, costly and time consuming administrative procedures to estimate stranded costs are avoided. Second, a properly-designed auction will result in valuations being set by the market.

AECC recognizes that auction and divestiture is not without certain drawbacks, however. For one thing, it may be problematic for the Commission to require that such an auction take place if the utility is an unwilling seller. It should be noted, though, that other states are demonstrating that successful divestiture programs can be implemented. A more difficult drawback concerns the limited applicability of an auction process to nuclear assets which figure prominently in Arizona. Federal restrictions on ownership of nuclear assets are likely to limit the field of bidders, artificially suppressing the value obtained from a winning bid. Therefore, auction and divestiture may not be a preferred option when nuclear facilities are involved.

b. Replacement Cost.

The replacement cost valuation approach is the best alternative method of calculating stranded costs. It serves as an administrative proxy for an auction, without the problems associated with a forced divestiture. Using this method, stranded costs are estimated on an asset-by-asset basis, by taking the difference between: (1) the net book value of a utility's generation assets plus regulatory assets (regulatory

value) and (2) the current replacement cost of those assets (market value), using the most cost-effective technology available. In this application, the replacement cost includes an adjustment for any capitalized energy value implicit in utility facilities that have variable energy costs lower than the replacement cost technology. It may also include an adjustment for life expectancy of each utility facility.

This method also matches up well with the definition of stranded costs in the Rules, where stranded costs are estimated by taking the difference between the regulatory and market values of a utility's generation assets. As with auction and divestiture, the regulatory value of a utility's generation assets is net book value. The market value of the utility's generation assets is represented by the assets' replacement cost, appropriately adjusted for capitalized energy value and life expectancy. Reflecting the long-term valuation of utility generation assets is preferable because it eliminates the hazards of estimating stranded costs by overemphasizing the impact of short-term periods when electricity prices may fall below long-run marginal costs. Such overemphasis leads to a stranded-cost-recovery windfall for utilities.

The hazard of a windfall to the utilities is especially acute when using the net revenues lost approach, discussed *infra*. The replacement cost valuation approach captures the essence of the long-term paradigm shift resulting from the introduction of retail competition. Periods of pricing below long-run marginal costs will likely be punctuated by periods of pricing above long-run marginal costs. Predicting the deviations and durations of

these periods is very difficult, but it is reasonable to expect the long-term trend to gravitate to the long-run marginal cost of the most cost-effective replacement technology.

c. Net Revenues Lost.

In contrast, the least desirable method for calculating stranded costs is the net revenues lost approach, which is advanced by Arizona Public Service and Tucson Electric Power, among others. The net revenues lost approach estimates stranded costs by taking the present value of the difference between the generation-related revenue the utility might collect under continued regulation and the generation-related revenue anticipated under competitive market pricing. Typically, the expected revenue under continued regulation is based on projections of the utility's generation costs, including return on rate base. This method presumes that stranded costs include **all** additional amounts consumers would pay for electric power if regulation continued and competition never occurred. Thus, it effectively saddles consumers with the operating, administrative and general costs that would have been expected if regulation were to continue into the foreseeable future.

Even though stranded costs are limited to fixed costs plus regulatory assets, the mathematics of the net revenues lost method results in a direct correlation between operating cost assumptions and the stranded cost estimates. Thus, for every one-dollar increase in the assumed present value of future operating costs or, administrative and general costs, there is a one-dollar increase in stranded costs. Moreover, by combining this method with a customer-paid transition charge designed to

recover one hundred percent of stranded costs, as the Affected Utilities have proposed, the very purpose of moving to a competitive market would be entirely defeated.

The objective of stranded cost calculations is to identify the generation-related fixed costs and regulatory assets that **might** not be recovered under competitive market pricing. Yet, ironically, the estimate of stranded costs which results from a net revenues lost calculation is driven by the assumptions concerning future operating, administrative and general costs that would have been incurred had competition not been introduced. In short, the more inefficient organizations under the current regime will have the highest stranded costs, a burden the customers would unfairly have to shoulder. On the other hand, if utilities are given the proper incentive to undertake mitigation actions, actual future operating, administrative and general costs should decline on a unit-cost basis. AECC recommends placing the burden for failing to take reasonable mitigation measures on the utilities.

Another significant problem with the net revenues lost approach is its dependence on assumptions regarding the highly speculative future market price of power. This problem will not occur using auction and divestiture. The market value of the utility's generation assets will be set by the winning bidder. Similarly, under the replacement cost approach, the long-term market value of the utility's generation assets will be set at the cost of the replacement technology.

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d. Replacement Cost and Net Revenues Lost Hybrid.

Notwithstanding the above, the net revenues lost approach could have qualified application for estimating stranded costs on a year-to-year basis, if the Commission were to designate a limited transition period of three to five years and the approach were combined with replacement cost valuation. This hybrid approach to calculation, recovery, and mitigation of stranded costs would be subject to the following conditions:

(1) Designation of a limited transition period of three to five years for calculation and recovery of stranded costs;

(2) Stranded cost calculation using a hybrid of the replacement cost valuation and net revenues lost approaches, whereby

(a) The net revenues lost approach is used to estimate stranded cost on a year-to-year basis;

(b) Total stranded costs are calculated using the replacement cost valuation method. This calculation provides the maximum allowable stranded costs over the transition period, providing an upper limit on annual stranded costs;

(3) Customers pay for a portion of stranded costs by a transition charge levied on distribution service. During any given year, the transition charge funds only recovery of stranded costs associated with that same year;

(4) The portion of stranded costs recovered through the transition charge declines each year. As such, the overall, unweighted percentage falls within the lower-to-middle portion of the 25 to 50 percent range, i.e., 35 percent;

(5) Affected Utilities will bear the risk associated with any stranded costs (associated only with the competitive market) that are not recovered. Affected Utilities will therefore be free to implement their chosen mitigation measures and will be entitled to retain the financial benefits when their mitigation efforts are successful (subject to any required adjustments associated

with the portion of their retail business still receiving Standard Offer service);

(6) "True-ups" are limited to adjustments for deviations from the market price of power;

(7) At the end of the transition period, the transition charge will cease and Affected Utilities will no longer be able to recover stranded costs.

By defining complementary roles for both net revenues lost and replacement cost valuation, the hybrid approach utilizes the two methods supported by Affected Utilities and consumers, respectively, in the Stranded Cost Working Group. This approach has the advantage of providing for a year-to-year calculation of stranded costs, while protecting consumers from the hazards associated with the net revenues lost method by capping total stranded costs using replacement valuation. The hybrid approach is an integral component of the total package proposed by AECC that addresses calculation, recovery, and mitigation of stranded costs. This total package is designed to achieve equity and efficiency objectives, maximize mitigation incentives, and allow for a meaningful transition from complete regulation of generation to a competitive retail market.

E. Issue 3a: What Is the Appropriate Treatment of Market Price?

Calculating stranded costs using a net revenues lost approach requires the use of market price assumptions. These assumptions capture the average price of **retail** generation sold in the competitive market by Arizona utilities. Components of the average retail market price will include the underlying wholesale price of power, plus a retail mark-up. The retail price to consumers will also include various ancillary services,

most of which require the use of generation resources. Examples of these services include regulation and frequency response, operating reserves (if not included in the generation price), voltage support from generation, and energy imbalance service to support retail transactions. Other generation-related services which will add to the market price are must-run units, back-up service, and supplementary power. Most of the time these services will be provided by the host utility and the associated net revenues should be an offset against stranded costs.

Basing the stranded cost calculation on the wholesale price of power rather than the retail price is erroneous because it leads to an overestimation of stranded costs. Furthermore, it is incorrect to presume that the relevant underlying wholesale price is the "hourly spot" market. Many retail customers will want price certainty. Consequently, they will pay a premium that will be incorporated into the retail market price. Therefore, the appropriate underlying wholesale price should be a blend of spot and longer-term pricing, which, in turn, will be marked up to a retail price.

F. Issue 3b: What Are the Implications of Financial Accounting Standard No. 71 Resulting from Your Proposed Approach?

The degree to which FAS 71 may be invoked under AECC's hybrid approach will vary according to the circumstances of the individual utility, the magnitude of stranded costs identified, the ameliorating effects of the phase-in, and the extent to which the utility anticipates it can successfully mitigate its stranded costs. However, irrespective of the ultimate impacts, accounting rules should not drive regulatory policy.

G. Issue 4: Should There Be a Limitation on the Time Frame over Which Stranded Costs Are Calculated?

This question presumes that stranded costs will be calculated following a net revenues lost approach that utilizes annual data that can be cut-off at a date certain. It is AECC's position that a method that provides a total stranded cost estimate at the outset, such as auction and divestiture, or replacement cost valuation is preferred. However, if stranded costs are to be calculated using annual data, then the period subject to that calculation must be limited to no more than a three to five year transition period. In addition to AECC, a similar limitation period is favored by Staff, RUCO, ENRON, the City of Tucson and Arizona Consumers Council. This limitation period is consistent with the replacement cost/net revenues lost hybrid approach proposed by AECC as well.

H. Issue 5: Should There be a Limitation on the Recovery Time Frame for Stranded Costs?

There should be a limitation on the period over which stranded costs are recovered. As discussed previously, stranded costs can be calculated on a year-to-year basis, and customers should only pay for stranded costs associated with that year. In designing the recovery mechanism this way, the important objective of a "price cap" would be accomplished, as discussed *infra*.

Furthermore, limiting the calculation/recovery period to three to five years provides utilities with a reasonable period during which they can seek to recover their above-market generation costs through Commission approved transition charges.

At the same time, the finite recovery period affords customers certainty regarding when their obligation to pay these transition charges will end. Notably, with transition charges in California scheduled to decline significantly in early 2002, it will be very important that Arizona's economic climate not be disadvantaged for very long thereafter.

The transition charge should also be designed to decline each year achieving a gradual weaning away from reliance on this non-market mechanism. With each year of experience in a competitive environment, and proper incentives, incumbent utilities will identify new mitigation opportunities, diminishing the importance of the transition charge in recovering stranded costs.

I. Issue 6: Who Should Pay for Stranded Costs and Who, if Anyone, Should Be Excluded?

Under the Rules, a transition charge to accomplish stranded cost recovery may only be levied on purchases made in the competitive market. When the Commission adopted the Rules, it was determined that those customers who would not be participants in the competitive market would pay for stranded costs in their regulated Standard Offer rates.

This line of reasoning applies to special contract customers, as a class of customers taking bundled utility service at Commission-approved rates. Because special contract customers are not participants in the competitive market, they should not pay stranded cost charges beyond what is already included in their current contract rates. The Rules go so far as to deem these customers to be ineligible for participation in the

competitive market while their contracts are in effect, unless the parties agree otherwise:

> Retail customers served under existing contracts are eligible to participate in the competitive market prior to the expiration of the existing contract only if the Affected Utility and the consumer agree that the retail consumer may participate in the competitive market.

R14-2-1604(F).

Thus, whenever the Rules distinguish between customers participating in the competitive market and those not participating, special contract customers should be considered a subset of the non-participants' group. If the Rules continue to limit stranded cost charges to those customers who participate in retail access, then special contract customers would not pay stranded cost charges, in keeping with that principle. If the Rules are changed to allow a stranded cost recovery charge to be levied on non-participating customers, then any protections afforded the non-participants should be applied to the special contract customers as members of that group. For example, if non-participating customers were made to pay a transition charge, AECC recommends that such a charge be accompanied by the two important conditions supported in a consensus recommendation in the Report of the Stranded Cost Working Group:

> (1) The price paid to the utility for generation is reduced by the amount of the transition charge, such that the final price for power paid by these customers is not increased.
>
> (2) The Rules' existing treatment of self-generation, demand-side management, and other demand reductions unrelated to retail access is not changed.

These essential provisions apply just as much to special contract customers as to standard tariff customers. If a

stranded cost charge is levied on special contract customers, their special contract 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. (Or equivalently, a portion of the special contract rate could be deemed to be a transition charge.) Special contract customers are entitled to the same price cap provisions that are necessary for all customers generally - and for non-participating customers in particular. Special contract customers should not be singled out to bear discriminatory cost increases under the guise of stranded cost recovery.

Upon the expiration of a special contract and the procurement of competitive power by the customer, the stranded cost charge for the former special contract customer should be determined using the principles of "proportionality" as recommended for all customers by a consensus of the Stranded Cost Working Group. In accordance with this consensus principle, stranded costs should be allocated among customer classes "in a manner consistent with the specific Affected Utility's current rate treatment of the stranded asset, in order to effect a recovery of stranded costs that is in substantially the same proportion as the recovery of similar costs from customers or customer classes under current rates." (Report of the Stranded Cost Working Group, p. iv) This provision is critical for preventing cost-shifting among customers in the recovery of stranded costs. Indeed, it was singled out by Dr. Fessler, one of the witnesses for Tucson Electric Power, as an important principle of stranded cost allocation.

The Rule further provides that:

> Any reduction in electricity purchases from an Affected Utility resulting from self-generation, demand side management, or other demand reduction attributable to any cause other than the retail access provisions of this Article shall not be used to calculate or recover any Stranded Cost from a consumer.

R14-2-1607(J). The reasoning behind this latter provision is straightforward. Options such as self-generation and demand-side management have been available to customers for many years. These demand reductions are business risks to the utility which pre-date retail access. 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 now as a pretext to start insulating utilities from these ordinary business risks. Thus, the Commission found that "there is no compelling reason to impose Stranded Cost responsibility on self generators under these Rules, when none has been imposed in the past." (Opinion and Order, Appendix B, p. 49) This reasoning should continue to be applied.

The Rule provides that in determining stranded cost charges, the Commission should consider the applicability of stranded costs to interruptible customers. The Commission was correct in singling this service out for special consideration. Generation capacity is not constructed to provide interruptible service. Consequently, when an interruptible customer elects to purchase competitive power, there is no stranded investment that is left behind. Therefore, there should be no stranded cost charges assigned to a service that had been interruptible under the customer's previous arrangement with the Affected Utility.

The justification offered by the utilities for stranded cost collection - the "obligation to construct" -- does not apply to this type of service.

J. Issue 7: Should There Be a True-up Mechanism and, if So, How Should It Operate?

If the recovery mechanism design incorporates an equitable and efficient sharing of responsibility for stranded cost recovery, then there is little need for a true-up, with the possible exception of adjustments for deviations from forecasted market price.

If the utility is placed sufficiently at risk for stranded cost recovery at the outset of the program, there is no need to reduce stranded costs later through a true-up, after mitigation actions are successful. In fact, such a true-up would be counterproductive, because it would dilute the utility's incentive to undertake mitigation activities.

The area in which a true-up might be appropriate is deviations from forecasted market price, particularly if the net revenues lost approach is used. The net revenues lost approach is calculated by taking the net difference between (1) the generation-related revenues the utility would have earned had regulation continued, and (2) the generation-related revenues earned as a result of introducing retail competition in generation services. Estimating the latter term requires a forecast of market price of generation over the stranded cost calculation period. Underestimating this price would result in an overestimation of stranded costs; conversely, overestimating market price would result in an underestimation of stranded

costs.

Because, unlike mitigation, the setting of market price in a competitive market should be independent of any individual supplier's control, it is possible to establish a market-price-related true-up mechanism that does not distort behavior. However, AECC cautions against designing a true-up mechanism which attempts to achieve an exact correction for deviations from forecasted prices, with the concomitant regulatory and administrative burdens. Instead, the objective of a market-price-related true-up should be one of protecting both sides from significant deviations from expectations. In this way, a true-up can be designed to be triggered if average market price over a given period (e.g., one year) deviates a given percentage (e.g., 10 percent) from the market price assumption used in estimating stranded cost.

This adjustment could be accomplished by either a rebate, a reduction of stranded costs on a going-forward basis, or an acceleration of the termination date of the stranded cost calculation period. While a rebate may generally be the least desirable approach from an administrative standpoint, it may be the best approach if a true-up is triggered in the final year of the stranded cost calculation/recovery period.

K. Issue 8: Should There Be a Price Cap or Rate Freeze?

A price cap is an essential part of the development of a stranded cost recovery program. In addition, rate ceilings on traditional, bundled service, which are already in effect for certain utilities, should be continued for Standard Offer service.

In the context of stranded cost recovery in Arizona, incorporating a price cap into the design of the stranded cost recovery program means that, for any customer, the sum of the transition charge plus delivery charges (i.e., transmission, distribution, ancillary services, system benefits charge) plus the market price of generation (used in calculating stranded cost) does not exceed current rates for that customer. The purpose of a price cap in this context is to design the stranded cost recovery program in a way to ensure that the final delivered price to consumers under competition is no greater than under regulation.

Note that the price cap is accomplished not by regulating the price of generation - which, of course, under competition is set by the market; instead, the price cap results from the design of the transition charge, which is constrained to be no greater than the contribution to stranded costs that a customer makes under regulated rates. The objective of a price cap can be met by calculating stranded costs on a year-to-year basis, and by having customers pay only for stranded costs associated with that year.

AECC does not support a price freeze.

L. Issue 9: What Factors Should Be Considered for Mitigation of Stranded Costs?

By their nature, mitigation actions are an integral part of corporate strategy that should be governed by the principles of risk and reward, rather than regulatory prescription or second-guessing. The best mitigation incentive is for the utility to be at risk for a substantial portion of its

stranded costs, and to be financially rewarded when its mitigation efforts are successful. This is accomplished by designing the transition charge to cover no more than 50 percent of stranded costs in a given year. Then, the utilities can be left to implement whatever mitigation actions they believe to be most effective.

This type of incentive mechanism relies upon the basic principles of the marketplace to guide utilities towards efficient mitigation strategies and represents a significant step in effecting a transition from a regulatory to a competitive paradigm for the Affected Utilities.

III. The Regulatory Contract.[4]

A. The Affected Utilities Bear the Burden of Proving That They Have a Binding and Enforceable Contract with the State of Arizona for the Generation of Electricity.

The party asserting the creation of a contract by statute must overcome the presumption against its formation, and courts are cautious both in identifying a contract within the language of a regulatory statute and in defining the outlines of any contractual obligation. National Railroad Passenger Corp. v. Atchison, Topeka, and Santa Fe Railroad, 470 U.S. 451, 466 (1985); Hoffman v. City of Warwick, 909 F.2d 608, 614 (1st Cir. 1990); McGrath v. Rhode Island Retirement Board, 906 F. Supp. 749, 759 (D.R.I. 1995). "[A]bsent some clear indication that the legislature intends to bind itself contractually, the presumption is that 'a law is not intended to create private contractual or vested rights but merely declares a policy to be pursued until the

[4] The following analysis regarding the nonexistence of a regulatory contract pertains to the generation of electricity only.

legislature shall ordain otherwise.'" National Railroad, 470 U.S. at 465-66 (quoting Dodge v. Board of Education of City of Chicago, 302 U.S. 74, 79 (1937)).

Here, the Affected Utilities clearly bear the burden of demonstrating that they entered into a binding and enforceable contract with the State of Arizona for the generation of electricity. In order to prove this, the Affected Utilities must proffer evidence of a clear intent by the State of Arizona to bind itself contractually and perpetually. The reason that no such evidence has been offered is because it does not exist.

B. There Is No Evidence of a Written Contract.

The Affected Utilities have argued,[5] by issuing a Certificate of Convenience and Necessity ("CC&Ns") to a public service corporation, the Commission grants them a contract right to a monopoly over the generation of electricity for the defined service area. However, neither A.R.S. § 40-281 (the statute which authorizes the Commission to issue CC&Ns), nor the CC&N's themselves, provide for the formation of a contract or the guaranty of a monopoly.

Section 40-281 says nothing about CC&Ns bestowing monopoly rights or creating a contract. Likewise, the utilities have no basis upon which to look to the Arizona Constitution to supply the missing terms of its claimed contractual entitlement to a perpetual monopoly. The constitutional provision addressing the Commission's responsibility for public service corporations "is silent as to any concepts of 'regulated monopoly.'" Mountain

[5] Several of the Affected Utilities are currently litigating the issue of a regulatory contract in State Court. The disposition of those cases is pending.

States Tel. And Tel. Co. v. Arizona Corporation Comm'n, 132 Ariz. 109, 113, 644 P.2d 263, 268 (Ct. App. 1982). Indeed, the only constitutional provision addressing monopolies provides that "[m]onopolies and trusts shall never be allowed in the State." Ariz. Const. Art. XIV § 15 (emphasis added). And the Constitution expressly prohibits any "law granting irrevocably any privilege, franchise, or immunity . . . ." Id. at Art. II § 9. (emphasis added). Clearly, there is no writing from which the utilities can reasonably construe a contract with respect to generation of electricity.

C. There Is No Evidence of an Implied Contract.

In apparent recognition that there is no evidence of a written contract, the Affected Utilities have argued that their right to an exclusive and perpetual monopoly over generation is "implied" from the conduct of the regulators who, over the years, have allowed them to function as *de facto* monopolies. This argument fails for several reasons.

1. The Commission's Authority Has Always Been Based on and Delineated by Protecting the Public Interest.

The fact that utilities have been permitted to function under a monopoly regime does not, *ipso facto*, equate to a contractual right to so function. Rather, the decision to allow the utilities to function under a monopoly regime is merely a product of a duty conferred on the Corporation Commission by the Constitution and Arizona law to protect the public interest.

Unlike most state agencies, the Commission's roots lie in the Arizona Constitution. The Constitution established the Commission as an elected body with "full power" to regulate, set

rates, establish classifications, and make reasonable rules for public service corporations, including electric utilities. Ariz. Const. Art. XV § 3. The Constitution also gives the Commission the power to amend or repeal any of its classifications, rates and orders. Id.[6] The framers of the Constitution intended the Commission to serve as an independent branch of government, exercising legislative, judicial, executive and administrative functions. Arizona Corporation Comm'n v. Woods, 171 Ariz. 286, 291-92, 830 P.2d 907, 812-13 (1992). In exercising its broad powers, the Commission is charged with acting to further the "public interest." Id.

In addition to the enumerated powers that the Constitution vests in the Commission, the Constitution provides that the legislature may "enlarge the powers and extend the duties of the Corporation Commission." Ariz. Const. Art. XV § 6. Accordingly, in 1912, the legislature adopted the Public Service Corporation Act (now A.R.S. § 40-101 *et seq.*), which sets out the statutory powers and duties of the Commission, as well as the procedures under which it is to operate. Under the Act, the legislature authorized the Commission to issue CC&Ns to public service corporations. A.R.S. § 40-281. Under section 40-281, the Commission may issue a CC&N only upon a showing that it "would serve the public interest." James P. Paul Water Co. v. Arizona Corporation Comm'n, 137 Ariz. 426, 429, 671 P.2d 404, 407 (1983).

In James P. Paul, the Arizona Supreme Court provided, in no uncertain terms, that CC&Ns are subject to rescission and/or modification at any time consistent with the public interest. The

[6] See also A.R.S. § 40-252.

court explained its basis for this rule as follows:

> The monopoly is tolerated only because it is to be subject to vigilant and continuous regulation by the Corporation Commission and is subject to rescission, alteration or amendment at any time upon proper service when the public interest would be served by such action.

James P. Paul Water Co. v. Arizona Corporation Comm'n, 137 Ariz. 426, 429, 671 P.2d 404, 407 (1983) (emphasis added) (quoting Davis v. Corporation Comm'n, 96 Ariz. 215, 218, 393 P.2d 909, 911 (1964)).

Based on the foregoing, it is clear that to the extent that the State of Arizona has "tolerated" regulated monopolies, it has done so only by virtue of advancing and protecting the public interest. Stated another way, any monopoly privileges that have been conferred on the utilities have been bestowed on them not as a matter of contract right, but because it is - or was at the time - in the public interest.

2. Under Similar Circumstances, the New Hampshire Supreme Court Recently Held That CC&Ns Do Not Give Utilities a Perpetual Contract Right.

In Appeal of Public Serv. Co. of New Hampshire, 676 A.2d 101 (N.H. 1996), the New Hampshire Supreme Court addressed the same issues now before this Commission. The essential question presented was whether the utility commission of that state could permit competition in generation when the commission had previously issued a CC&N to the plaintiff utility. Id. at 103. New Hampshire's regulatory scheme and case law are very similar to Arizona's. For example, New Hampshire law provided: (1) that every entity seeking to operate as a public utility was required to obtain a CC&N from the commission; (2) that the

Commission was to grant a CC&N based on a finding that it would be in the public interest to do so; and (3) that the commission had authority to amend or set aside any order made by it. Id. at 103-07.

The New Hampshire Supreme Court held that "legislative grants of authority to the PUC [New Hampshire's analog to the ACC] should be interpreted in a manner consistent with the state's constitutional directive favoring free enterprise." Id. at 104. The court held that any limitations on the right to free competition must be construed narrowly, "with all doubt resolved against the establishment or perpetuation of monopolies." Id. Furthermore, in the face of the constitutionally protected right to competition, the statutes "should not be interpreted as creating monopolies capable of outliving their usefulness." Id.

The court found that, in New Hampshire, monopolies have been tolerated only to the extent consistent with the promotion of the public good:

> The law was designed for the benefit of the public and not of the utilities, although it inevitably operates to the advantage of both. The utility has no vested right to its monopoly. It must meet competition whenever, for any reason, the public good will be thereby promoted.

Id. at 104.

The court held that the commission was "both authorized and obligated to grant a competing electric utility franchise when it determines that such grant would serve the public good." Id. at 103. The court rejected the utility's statutory claim, and pointed out that to read the statute to bar the commission from granting a competing CC&N would contradict the intent of the

legislature depriving the commission of "authority to grant franchises for the public good." Id. at 104.

Finally, the court pointed out that prior commission orders had always recognized that, to the extent monopoly status was conferred, it was "conditioned on continued subservience to the public good." Id. at 105. The court said that a commission order expressly granting "exclusive service territories" was subject to the commission's statutory power to amend or set aside another order. Id. at 106.

The court's analysis is squarely on point. Like New Hampshire, Arizona's Corporation Commission has generally followed a practice of permitting regulated monopolies because that scheme best served the public interest at one time. Because changing technology in the electric industry has dramatically altered both the economics and feasibility of competitive generation, the Commission acted well within its constitutional authority when it decided to permit competitive pricing of generation so as to better serve the public. There is no reliable evidence of an "implied regulatory contract" which would prohibit this course of action.

CONCLUSION

AECC respectfully requests that the Commission not change, modify or amend the Electric Competition Rules except as recommended herein and, further, that it interpret those rules in a manner consistent with the position taken by AECC on each of the eleven stranded cost issues as set forth herein. In addition, AECC requests that the Commission deny the existence of a regulatory contract with respect to the generation of electricity.

DATED this 16th day of March, 1998.

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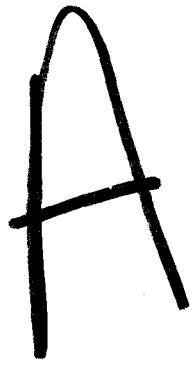

Recommended additions to the Competition Rule

1. R14-2-1607.(B)

The Commission shall allow recovery of unmitigated Stranded Cost by Affected Utilities IN ACCORDANCE WITH THE PROVISIONS OF R14-2-1607(I).

2. R14-2-1607.(G)

~~The~~ AN Affected Utilit~~ies~~Y shall file estimates of unmitigated stranded cost AT LEAST EIGHT MONTHS PRIOR TO THE DATE IT REQUESTS STRANDED COST RECOVERY CHARGES TO BEGIN. Such estimates shall be fully supported by analyses and by records of market transactions undertaken by willing buyers and sellers.

3. R14-2-1607.(I)

The Commission shall, after hearing and consideration of analyses and recommendations presented by the Affected Utilities, Staff, and intervenors, determine for each Affected Utility the magnitude of Stranded Cost, and appropriate Stranded Cost recovery mechanisms and charges. In making its determination of mechanisms and charges, the Commission shall BALANCE UTILITY AND CUSTOMER INTERESTS BY considerING at least the following factors:

1. The impact of Stranded Cost recovery on the effectiveness of competition;

2. The impact of Stranded Cost recovery on customers of the Affected Utility who do not participate in the competitive market;

3. The impact, if any, on the Affected Utility's ability to meet debt obligations;

4. The impact of Stranded Cost recovery on prices paid by consumers who participate in the competitive market;

5. The degree to which the Affected Utility has mitigated, or ~~offset~~ SHOULD BE AT RISK FOR MITIGATING, Stranded Cost;

6. The degree to which some assets have values in excess of their book values;

7. Appropriate treatment of negative Stranded Cost;

8. The time period over which such Stranded Cost charges may be recovered. The Commission shall limit the application of such charges to a specified time period;

9. The ease of determining the amount of Stranded Cost;

10. The applicability of Stranded Cost to interruptible customers;

11. The amount of electricity generated by renewable generating resources owned by the Affected Utility.

4. R14-2-1607.(M)

STRANDED COST SHALL BE ALLOCATED AMONG CUSTOMER CLASSES IN A MANNER CONSISTENT WITH THE SPECIFIC COMPANY'S CURRENT RATE TREATMENT OF THE STRANDED ASSET, IN ORDER TO EFFECT A RECOVERY OF STRANDED COSTS THAT IS IN SUBSTANTIALLY THE SAME PROPORTION AS THE RECOVERY OF SIMILAR COSTS FROM CUSTOMERS OR CUSTOMER CLASSES UNDER CURRENT RATES.