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BEFORE THE ARIZONA CORPORATION COMMISSION

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

~~Arizona Corporation Commission~~
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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 its Initial Brief and Legal Memorandum in Support of Initial Brief as required by the Commission's Order in the above-referenced docket.

RESPECTFULLY SUBMITTED this 16th day of March, 1998.

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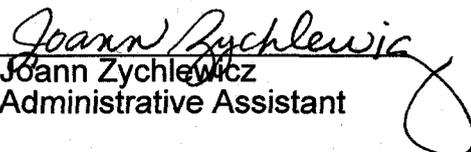
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1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

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10 IN THE MATTER OF THE COMPETITION) DOCKET NO. RE-00000C-94-0165
11 IN THE PROVISIONS OF ELECTRIC)
12 SERVICES THROUGHOUT THE STATE) **CITIZENS UTILITIES COMPANY'S**
13 OF ARIZONA.) **INITIAL BRIEF**
14 _____)
15

16 In accordance with the procedural orders, Citizens Utilities Company ("Citizens")
17 submits its Initial Brief. Also being submitted today is Citizens' Legal Memorandum in
18 Support of Initial Brief.

19 Before turning to the eleven questions set forth in the procedural orders, Citizens will
20 establish two foundations to support its policy discussion.¹

21 **FIRST FOUNDATION: THE SCOPE OF HISTORICAL REGULATORY COMPACT.**

22
23 **A. Lessons Learned From The Hawaii Public Utilities Commission's Recent**
24 **Affirmation Of The Long-Standing Regulatory Compact.**
25

26 A recent case that actually involved Citizens and one other party to this case is
27 particularly instructive concerning the nature of the regulatory compact.² *In Citizens Utilities*
28 *Company, Kauai Electric Division, Docket Nos. 94-0097 and 94-0308, dated August 7,*
29 *1996,*³ the Hawaii Public Utilities Commission decided, among other things, whether

1 The controlling legal authority is set forth in Citizens' accompanying legal memorandum.

2 This case is discussed here instead of in the accompanying legal memorandum because it is the decision of another utility commission, not controlling legal authority.

3 The first 17 pages of the Hawaii PUC's order are attached as Exhibit A. Citizens will provide a copy of the entire opinion upon request.

1 shareholders should bear any portion of the prudent costs associated with restoring electric
2 service following the devastation wrought to the Island of Kauai by Hurricane Iniki on
3 September 11, 1992. Despite a massive effort, electric service was not restored until some
4 four months later.⁴ The Hawaii PUC found the total uncompensated restoration cost to be
5 \$33.7 million. Slip Opinion at 20-21. Kauai Electric has approximately 25,000 customers, so
6 the cost per customer was over \$1300. This is on the same order of magnitude as some of
7 the stranded cost estimates for other utilities in this case. The revenue requirement
8 associated with just the restoration plant would amount to a 14% rate increase for Kauai
9 Electric's customers. *Id.*

10 Among other things, Kauai Electric relied upon the regulatory compact to support its
11 claim that a utility is allowed to recover the prudent costs of restoring service following a
12 major storm. Just like the Staff in this case, the Hawaii Consumer Advocate denied the
13 existence of the regulatory compact and argued that shareholders should be 100%
14 responsible for the restoration costs. The Department of Defense took the same position in
15 Hawaii that it takes in this case: shareholders and customers should share in the restoration
16 costs 50-50.

17 Following its lengthy deliberation over the evidence and legal precedent, the Hawaii
18 PUC determined that it would be unjust and unreasonable for Citizens' shareholders to bear
19 the prudent costs of the restoration. The regulatory compact would not allow such a result.

20 Our decision is based in a large part on the long-standing regulatory
21 compact. The regulatory compact has two aspects: (1) in return for a
22 monopoly franchise, utilities accept the obligation to serve all comers; and
23 (2) in return for agreeing to commit capital necessary to allow the utilities

⁴ Approximately one-third of Kauai Electric's transmission and distribution plant was destroyed.

1 to meet the obligation, utilities are assured a fair opportunity to earn a
2 reasonable return on the capital prudently committed to the business. In
3 *Wash. Util. and Trans. Comm'n v. Puget Sound Power & Light Co.*, 62
4 P.U.R.4th 557, 581 (1984), the Washington Commission explained the
5 regulatory compact in this fashion:
6

7 The social and economic compact of utility regulation
8 begins with the premise that a regulated utility has an
9 obligation to serve the public. [A] utility possesses an
10 unending obligation to provide service to anyone within the
11 service territory of that utility who demands service in
12 accordance with approved tariffs.
13

14 However, in order for the social duty to serve to be viable,
15 the compact must also provide for a utility to recover
16 expenses it prudently undertakes to meet the obligation.
17

18 Slip Opinion at 13. (Emphasis added in the first paragraph; original in the third paragraph).
19

20 In the recent hearings in this case, the duty-to-serve aspect of the regulatory compact
21 was discussed in abstract terms. The Hawaii PUC had just seen Citizens' duty to serve
22 fulfilled after a mammoth natural disaster. Accordingly, its discussion of a utility's duty to serve
23 was more concrete.

24 In light of Citizens' (through KE) duty to serve and to make prudent
25 investments to meet its obligation, it was expected that Citizens would
26 quickly restore and repair its damaged facilities immediately after Iniki.
27 Indeed, conscious of its obligation and relying on past regulatory practice
28 that recognized the regulatory compact, Citizens voluntarily and
29 expeditiously provided Iniki restoration and recovery support to the island
30 of Kauai. It would be fundamentally unfair to change the regulatory rules
31 after a disaster has occurred and restoration efforts have been completed
32 by Citizens. It would be unjust and unreasonable to disallow Citizens an
33 opportunity to earn a return on its prudent investment in used and useful
34 property.
35

36 Slip Opinion at 14. (Emphasis added.)

37 Again, much like this case, parties maintained that, because regulation was allegedly
38 supposed to emulate competition, utility shareholders should bear the cost of storm restoration

1 just like the shareholders of a competitive company. The Hawaii Commission made short work
2 of such superficial comparisons.

3 The Consumer Advocate argues that the commission should decide this
4 issue in a manner that emulates a competitive market. In a competitive
5 market, the Consumer Advocate asserts that businesses must sustain the
6 losses resulting from a natural disaster. By emulating such a market, the
7 Consumer Advocate contends that Citizens' shareholders should be held
8 responsible for any Iniki-related losses.
9

10 We find that KE's duty to serve the public precludes any comparisons of
11 KE to an unregulated business in a competitive market. In a competitive
12 market, a business must first decide whether to restore or to cease
13 operations. It will cease operations if it determines that it will not be able
14 to recoup its restoration costs and remain competitive with its competitors.
15 If it restores operations, the business will attempt to recover its restoration
16 expenses by increasing either prices or the volume of business. On the
17 other hand, as a regulated utility, KE has a duty to restore service as
18 quickly as possible. It has no option to cease operations. Furthermore,
19 KE cannot increase its rates without commission authorization, which
20 entails a lengthy rate case proceeding where the Consumer Advocate
21 and other interested parties have an opportunity to scrutinize and
22 evaluate KE's rate increase request for reasonableness.
23

24 Slip Opinion at 14-15. (Emphasis added.)

25 Finally, much like the Goldwater Institute and the Attorney General in this case, the
26 Hawaii Consumer Advocate maintained that so-called "excess earnings" by utilities supported
27 allocating restoration costs to shareholders.

28 The Consumer Advocate also contends that Citizens' shareholders should
29 bear the Iniki-related restoration and repair costs due to "excess earnings"
30 by the shareholders in the past. . . . Thus, the Consumer Advocate
31 concludes that it would be fair and equitable for Citizens' shareholders to
32 pay for all Iniki-related restoration and repair costs.
33

34 We decline to adopt this novel theory as applied by the Consumer
35 Advocate to the recoverability of KE's prudently incurred, used and useful
36 capital investment. It would set a dangerous precedent to limit a utility's
37 return on prudently incurred, used and useful property based on the
38 utility's market-to-book ratio. The Consumer Advocate has failed to point
39 to any jurisdiction that has adopted this approach. The fact that the

1 market-to-book ratio approach does not distinguish between a utility's
2 regulated and unregulated businesses is also troubling. Finally, we
3 question whether a high market-to-book ratio indeed suggests excess
4 earnings.

5
6 Slip Opinion at 15-16. (Emphasis added.)

7 The Hawaii PUC concluded: it is just, reasonable, and in the public interest for KE's
8 ratepayers to bear the Iniki-related restoration and repair costs prudently incurred by Citizens.

9 Slip Opinion at 16. (Emphasis added, footnote omitted.)

10 A summary of the Hawaii PUC's conclusions concerning the regulatory compact
11 follows:

- 12 1. The regulatory compact is long-standing.
- 13 2. The regulatory compact has two aspects:
 - 14 a. In return for a monopoly franchise, a utility accepts the obligation to
15 serve all customers; and
 - 16 b. In return for agreeing to commit capital necessary to allow the utility to
17 meet its obligation, the utility is assured a fair opportunity to earn a
18 reasonable return on the capital prudently committed to the business
19 under rates established by the Commission.
- 20 3. It would be fundamentally unfair to change regulatory rules retroactively, after a
21 utility has committed capital in compliance with its duty to serve.
- 22 4. Superficial comparisons of competitive businesses to regulated utilities are
23 meaningless because:
 - 24 a. A utility has a duty to serve all comers and to promptly restore service
25 following a natural disaster. It cannot cease operations. In contrast, a

1 competitive business can studiously decide, based upon its forecast of
2 business conditions, whether to restore or to cease operations; and

3 b. A utility can only raise its rates after a lengthy, contentious hearing. A
4 competitive business can immediately raise rates to whatever it
5 estimates the market will bear. Further, its expected rate of return is
6 higher than that expected by a utility.

7 5. Claims of past over-earnings by utilities are fundamentally flawed. Further, use
8 of such analyses would set "dangerous precedent to limit a utility's return on
9 prudently incurred, used and useful property."

10 **B. Commission Staff Recognizes The Existence And Substance Of The**
11 **Regulatory Compact.**

12
13 Staff witness Dr. Kenneth Rose acknowledged that the regulatory compact exists (Tr.
14 X. pp. 3175-76) and that it is comprised of four elements:

- 15 1. A monopoly franchise granted to the utility;
- 16 2. The utility's obligation to serve;
- 17 3. Regulation of the utility's' rates with an authorized return on equity; and
- 18 4. The utility's reasonable opportunity to earn a reasonable return on and of its
19 investments.

20 (Tr. X, pp. 3169-71). Dr. Rose's description of the regulatory compact is completely
21 consistent with that given by the Hawaii PUC.

22 Dr. Rose described the compact alternatively as a "deal", an "agreement that was
23 somehow settled on by the parties," and a "bargain." He listed the parties to the regulatory

1 compact as the regulated utilities and the Commission, "acting on behalf of the customers."
2 (*Id.*, p. 3176).

3 **SECOND FOUNDATION: STRANDED COSTS ARE THE COSTS ASSOCIATED WITH**
4 **BUYING OUT THE REGULATORY COMPACT.**
5

6 There is little disagreement concerning the nature of the existence and nature of the
7 regulatory compact. Whether it is called an agreement, a contract, a deal or a bargain, there
8 are two parties to the compact -- the utilities and the Commission on behalf of the
9 customers. Whether it is characterized as an agreement, deal or bargain (these are all
10 synonyms for a "contract"), society has set certain rules governing a compact's
11 administration.

12 The legal rules concerning contracts are well-known. Over the years, public policy --
13 embodied in the common law, the United States and Arizona Constitutions and statutes --
14 has been that a just and ordered society requires that the sanctity of contracts be respected.
15 When a state or its agency is a party to a contract, it is perhaps even more important that the
16 state or agency keep its contractual commitments.

17 A useful analogy from contract law can now be drawn. When a party to a contract
18 wishes to be relieved of its obligations, it can, with the consent of the other party, buy-out the
19 contract. The buy-out price is set so that the party that is still to receive benefits under the
20 contract is left in the same position as it would have been in had the contract continued in
21 effect. Generally, the buy-out price is the parties' estimate of what a court would award as
22 expectation damages to the non-breaching party.

23 Since Arizona became a state and the Commission was established by the State
24 Constitution, utilities have operated under a regulatory compact with the Commission. With

1 respect to generation and other supply resources, the Commission now wishes to
2 fundamentally alter the compact by moving to competitive supply. That is the Commission's
3 right. But the Commission also has a corresponding duty to arrange for the buy-out of each
4 Affected Utility from the regulatory compact by providing for recovery of the stranded costs
5 that flow from the Commission's unilateral decision. The buy-out price should reflect
6 investors' expectations under regulation of a reasonable opportunity for a return of and on
7 their investments.

8 **COMMISSION QUESTION NUMBER ONE**

9 **SHOULD THE ELECTRIC COMPETITION RULES BE MODIFIED REGARDING**
10 **STRANDED COSTS, IF SO, HOW?⁵**

11
12 **A. The Rules May Not Bar Recovery Through Rates Of The Costs Of**
13 **Wholesale Power Purchase Contracts Approved By The Federal Energy**
14 **Regulatory Commission.⁶**

15
16 Virtually all power now provided to Citizens' electric customers is supplied by Arizona
17 Public Service ("APS") under a wholesale purchased-power agreement. The cost for this
18 power is passed directly to Citizens' customers, without mark-up, through a purchased
19 power and fuel adjustment clause ("PPFAC"). Accordingly, unlike utilities that have
20 substantial generation assets, Citizens has not and does not earn a return on the substantial
21 portion of the power requirements of its customers. The rates paid by Citizens for this power
22 are set by the Federal Energy Regulatory Commission ("FERC"), which has exclusive
23 jurisdiction over wholesale sales under the Federal Power Act. The filed rate doctrine

⁵ Citizens will submit a red-lined version of the Rules at the time it submits its reply brief in this docket. The red-lined version will reflect Citizens' final positions set forth in the reply brief.

⁶ Unless otherwise indicated, this section of the brief is based upon the testimony of Citizens witness Sean Breen. (Ex. Cit-1, Cit-2).

1 provides that rates filed with and approved by the FERC may not be altered at the state
2 level, and that state commissions may not bar local distribution companies from passing
3 such costs through to ratepayers. As a result, the filed rate doctrine will invalidate any
4 approach to stranded cost recovery that leads to under-recovery of the APS power purchase
5 contract costs.

6 The Commission has required Citizens to maintain its PPFAC to provide for pass-
7 through, without markup, of costs incurred through its purchased power contracts with APS.
8 The Commission has twice rejected attempts by Citizens to eliminate its PPFAC and has
9 ordered Citizens to continue recovery of its purchased power costs through the PPFAC. The
10 Commission justified this treatment by finding that Citizens was not a generating utility.

11 Citizens has earned nothing on the PPFAC bank balances, receiving only dollar-for-
12 dollar recovery. Further, in Citizens' last electric rate case, the Commission found that the
13 current long-term purchased power contracts between Citizens and APS, which have been
14 approved by the FERC, were reasonable and should be recovered from Citizens' customers
15 through the PPFAC. Nothing has changed to affect that determination.

16 These facts underscore that Citizens' shareholders have received no benefit from the
17 power supply contracts approved by the Commission. In fact, the Commission rejected
18 Citizens request to be at risk for changes in the cost of purchased power and allocated all
19 benefits and costs to customers. Putting aside the filed-rate doctrine, it would be
20 fundamentally unfair to cause shareholders to absorb any stranded costs associated with
21 purchase-power contracts when:

- 1 • shareholders have earned nothing on these payments;
- 2 • the Commission has found the purchases to be prudent; and
- 3 • customers have already received refunds when power costs declined below
- 4 forecasted levels.

5 The Commission cannot fairly saddle shareholders with stranded costs associated with an
6 approved contract, from which shareholders have never received any benefits.

7 The only event that is causing concern as to the recovery of the costs associated with
8 those contracts is the Commission's effort to restructure the electric utility industry. While
9 Citizens does not disagree with the Commission on the goal, the Commission cannot
10 summarily disregard 87 years of its past practice; it must provide an acceptable transitional
11 mechanism to permit full recovery of all costs associated with providing service under the
12 existing regulatory rules.

13 **B. The Rules Could Improperly Require Revenues From Collateral Services**
14 **To Be Allocated To Offset Stranded Costs.⁷**

15 A.A.C. R14-2-1607 states: "The Affected Utilities shall take every feasible, cost-
16 effective measure to mitigate or *offset* Stranded Costs by means such as expanding
17 wholesale or retail markets, or *offer a wider scope of services for profit, among others.*"
18 (Emphasis added.) The Rules as now stated would improperly include revenues from all
19 sources/services – even those unrelated to the incurrence of stranded costs or the provision
20 of utility services.
21

22 Citizens agrees that utilities should be required to make reasonable efforts to mitigate
23 avoidable stranded costs. However, this portion of the Rules states that revenues derived

1 from other aspects of the Affected Utilities' operations, including aspects unrelated to the
2 stranded costs or utility operations, should be used to reduce the level of recoverable
3 stranded costs. With the introduction of electric competition, a utility may make new at-risk
4 investments in competitive markets. If the utility were required to divert revenues from these
5 unrelated activities to offset stranded costs it would be unable to fairly compete against new
6 market entrants that had no stranded costs to offset.

7 **C. Full Recovery Of Unmitigated Stranded Costs Should Be A Rebuttable**
8 **Presumption.⁸**

9
10 Once a utility has made a showing of its efforts and results for mitigating its stranded
11 costs, the burden of proof that the utility has not taken all reasonable steps should be on the
12 party opposing full recovery.

13 **COMMISSION QUESTION NUMBER TWO**

14 **WHEN SHOULD AFFECTED UTILITIES BE REQUIRED TO MAKE A STRANDED**
15 **COST FILING PURSUANT TO A.A.C. R14-2-1607?⁹**

16
17 Stranded cost filings should not be required until well after the rules governing the
18 introduction of competition into the Arizona electric industry have been finalized. Through its
19 Decision No. 60351, the Commission set in motion a process to, in effect, re-visit approved
20 rules A.A.C. R14-2-1601 through R14-2-1616. The decision to do so was, in part, based on
21 allowing consideration of the findings of the various working groups that have submitted
22 reports on their activities and recommendations. A review of these reports shows that a host

⁷ Unless otherwise indicated, this section of the brief is based upon the testimony of Citizens witness Sean Breen. (Ex. Cit-1, Cit-2).

⁸ Unless otherwise indicated, this section of the brief is based upon the testimony of Citizens witness Sean Breen. (Ex. Cit-1, Cit-2).

⁹ Unless otherwise indicated, this section of the brief is based upon the testimony of Citizens witness Sean Breen. (Ex. Cit-1, Cit-2).

1 of issues concerning electric competition remain to be resolved. Further, the present
2 hearings will provide additional evidence for the Commission to consider. Until the
3 Commission reviews all the evidence and provides further guidance, it is simply not possible
4 for Affected Utilities to make responsive stranded cost filings. Once the Rules have been
5 established with finality, Affected Utilities should be allowed a reasonable opportunity to
6 consider the impact of the changes that have been made, and to restructure their
7 businesses accordingly. Not knowing the scope of changes to the Rules that may be made,
8 Citizens does not have a specific recommendation for what span of time would be
9 appropriate, but would suggest that it should reflect the extent of the changes made.

10 Unfortunately, the time needed to resolve the stranded cost issues (not to mention the
11 host of other yet-resolved issues identified in the working group process) could well absorb
12 most of the time remaining before the Rules' January 1, 1999, implementation date. Citizens
13 encourages the Commission to act quickly to set a more realistic date for initiating electric
14 competition.

15 Citizens favors starting competition for a manageable number of large commercial
16 and industrial customers (for instance those with loads exceeding 3 MW) as soon as
17 practicable, and to "flash-cut" to open competition for the remainder of customers at a later
18 time, for instance in 2000 or 2001. This schedule would allow for the orderly resolution of
19 stranded cost issues, the Commission's reconsideration of other aspects of the Rules, and
20 the resolution of the other administrative/logistical issues raised by the working groups.

1 **COMMISSION QUESTION NUMBER THREE**

2 **WHAT COSTS SHOULD BE INCLUDED AS PART OF STRANDED COSTS AND**
3 **HOW SHOULD THOSE COSTS BE CALCULATED?¹⁰**
4

5 Citizens agrees with the current Rules' definition of stranded costs and generally
6 concurs with the components of stranded costs defined in Stranded Cost Working Group
7 report. However, there are two additional areas of strandable costs that are not fully
8 addressed in the Working Group: non-generation-related costs and the costs of new
9 functions that will be required by a regulated local distribution company ("LDC") under open
10 access.

11 The Stranded Costs Working Group Report does not fully address the stranded cost
12 potential associated with non-generation utility functions including: metering and meter
13 reading, billing and collections, and customer information services. As Staff points out in the
14 Report: "Although the focus of this analysis was directed toward potentially strandable
15 generation costs, Staff believes that it is appropriate to recognize that, to the extent any
16 portion of the affected utilities' distribution business (i.e. customer metering and billing) is
17 similarly removed from the scope of regulation, additional stranded costs may result." (See
18 page 14.) While these strandable costs are in all likelihood of lower magnitude than
19 generation costs, they are potentially strandable and should be accorded the same
20 reasonable opportunity for full recovery.

¹⁰ Unless otherwise indicated, this section of the brief is based upon the testimony of Citizens witness Sean Breen. (Ex. Cit-1, Cit-2).

1 Introducing competition fundamentally changes the structure of the industry, not only
2 to the extent that it creates new competitive enterprises, but also how it will change the
3 operations of those components that will remain regulated. For instance, continuously
4 tracking, accounting, and reconciling energy supply and demand transactions between
5 distribution customers and tens, possibly hundreds, of electricity suppliers will require LDC's
6 to implement and operate new systems. Educating customers about how the industry is
7 changing and how these changes affect the way they will purchase electricity is another
8 example of a significant new activity that will fall to the LDC. The costs for start-up and on-
9 going operation of these functions are not currently reflected in the rates of any Arizona
10 utility, nor can any Arizona utility determine these costs at this time, given that the structure
11 and requirements of the restructured industry have not been fully defined. Although these
12 costs may not satisfy the definition of "stranded" costs (these will be newly-incurred, instead
13 of pre-existing), the Commission should definitely provide for their recovery.

14 There are two components of these implementation costs: start-up/one-time costs
15 and on-going costs of operation. The start-up/one-time costs for these new functions, while
16 not technically "stranded," should nonetheless be recoverable as part of customer charges
17 for the transition to open access, sometimes call "competitive transition charges" ("CTC").
18 Just as stranded costs result from regulatory restructuring, these new functions also result
19 from regulatory restructuring. Since the on-going costs for these new functions will be
20 caused mainly by those customers who elect competitive suppliers, the on-going operating
21 expense for these new functions should reasonably be borne by the new market entrants
22 and consumers participating in and enjoying the benefits of the competitive electricity
23 market.

1 Turning to the second part of Question Three (how should stranded costs be
2 calculated?) Citizens firmly supports a market valuation method for determining the stranded
3 costs of the vast majority of stranded costs associated with electric generation. In particular,
4 Citizens proposes that the value of generation-related stranded costs be determined through
5 an auction of generation assets and purchased power contracts. Stranded costs would be
6 established as the difference, if any, between the auction proceeds and book value of the
7 assets (or contract obligations in the case of purchased power contracts).

8 Participation in the auction would be voluntary. Any Affected Utility would be free to
9 enter the competitive market using its existing generation resources. However, if an
10 Affected Utility seeks to recover the above-market costs for any of its generation resources,
11 it could do so only by putting up all its resources for sale in the auction. By putting up all
12 generation resources, the magnitude of stranded costs is mitigated to the extent an Affected
13 Utility owns below-market price resources which offset a portion of its above-market price
14 resources. It is only fair if a utility seeks recovery of costs stranded by above-market
15 resources incurred under the regulatory compact, that it should be prepared to relinquish
16 offsetting below-market resources acquired under the same compact.

17 There is no barrier to including nuclear assets, jointly owned plants or encumbered
18 facilities in an auction. Capacity and energy from such a facility could be sold on the open
19 market under standard long-term contracts. The total realized from the sales would then be
20 compared to the book value for the facility to determine the stranded costs (positive or
21 negative) associated with the facility. (Tr. XIII, pp. 4068-70).

22 Not all generation would be included. Generation that is required for emergency
23 back-up, local voltage support, or other reliability function for the utility's transmission and

1 distribution system would not have to be put up for auction. The costs for these assets are
2 more properly recovered as part of a regulated utility's transmission and/or distribution
3 charges.

4 There are several advantages to the auction and divestiture approach, chiefly
5 including:

- 6 ● risk transfer;
- 7 ● mitigation of stranded costs;
- 8 ● rapid transition to true open competition; and
- 9 ● reduction of horizontal market power.

10 Citizens will discuss each advantage in order.

11 **Risk transfer.** Bidders in the auction would base their bids on what they believe
12 future market prices for power will be. By purchasing generation assets or contracts,
13 successful bidders would assume price forecasting risk, and in particular, the risk that future
14 power prices would be lower than projected. By contrast, under administrative
15 approaches that employ true-up mechanisms, customers would bear the risks of under-
16 forecasting future prices, and pay the differences between established stranded charges and
17 the actual amounts of above-market costs on a forward-going basis.

18 **Stranded cost mitigation.** There are two main ways Citizens' proposal would
19 mitigate stranded costs: by 1) requiring below-market resources to be included in the
20 auction; and 2) holding the auction while the marketplace is still in transition. Citizens has
21 already discussed how including below-market resources could mitigate stranded costs. A
22 rapid move to auction and divestiture can also help mitigate stranded costs.

1 The restructuring of the electric industry across the country has produced a flurry of
2 new business activity, as new market entrants jockey for position to acquire a share of the
3 new multi-billion dollar per year market for competitive power. In Massachusetts, California
4 and Maine, where auctions of utility generation assets and purchase power contracts have
5 been held, the sales proceeds have exceeded the underlying book value of the resources
6 sold by wide margins. For instance, Southern California Edison has recently selected
7 winning bidders for its sale of over 7500 MW of gas-fired generation plants and garnered a
8 sales price 2.65 times the book value of the plants in aggregate. Pacific Gas & Electric also
9 selected a winning bidder for three of its California plants that agreed to pay a price 30%
10 higher than book value. In Massachusetts, New England Electric System sold over 5000
11 MW of fossil-fuel and hydroelectric facilities for 45% over book value. Recently, Central
12 Maine Power selected the winning bidder in its sale of 1185 MW of generation that offered
13 3.5 times book value. Part of the reason these premiums have been earned is linked to
14 investors' expectations about profit potential inspired by the newness of the market
15 opportunity. Coupled with a robust competitive bidding process, these expectations can
16 contribute to higher prices in the auction process. Reports in industry periodicals suggest
17 that divestiture will be good for utilities that undertake it in the near-term. Arizona remains
18 on the leading edge of industry restructuring nationwide. Arizona can secure these
19 advantages if it quickly adopts Citizens' auction approach to stranded cost valuation.

20 **Rapid transition to true open competition.** Administrative approaches to stranded
21 cost valuation will likely require time-consuming, litigious, and expensive true-up proceedings
22 for many years into the future. In addition to the continuing expense, ongoing regulatory
23 involvement in the process will create motivations for gaming and could undermine investor

1 confidence. Under Citizens' approach, no true-up mechanisms or proceedings are needed.
2 In short, it will bring true open competition to the power supply industry "overnight," and
3 disentangle the Arizona power supply industry from any further encumbrance of price
4 regulation.

5 The auction and divestiture approach should also be significantly less expensive than
6 administrative approaches. While some up-front administrative work would be required to
7 set the rules for the auction this would be inexpensive compared to administrative methods
8 for valuation which will inevitably involve multiple parties litigating over the "correct" forecast
9 of market prices initially and during subsequent true-up proceedings.

10 **Reduction of horizontal market power.** Horizontal market power in the power
11 production chain could result if a limited number of market participants controlled a majority
12 of the competitive resources, thereby resulting in barriers to entry to new market players or
13 too few market participants. While bringing a number of other benefits, Citizens' approach
14 can effectively eliminate potential horizontal market power that may be held by existing
15 Affected Utilities. Whether this is an issue in Arizona is a judgment the Commission must
16 make.

17 Citizens does not give much credence to claims that a sale of assets within a short
18 time frame could lead to "fire sale" prices and potentially not attract many bidders.
19 Controlling the timing of the sale can avoid these potential pitfalls. For instance, conducting
20 the auction in stages over some span of time or scheduling to avoid overlap with similar
21 activities in nearby states are two obvious ways to mitigate these concerns. Further, the
22 experiences in other jurisdictions has been the opposite -- bidding has been robust and
23 prices have exceeded book values.

1 Finally, Citizens supports recovery of all regulatory assets such as deferred tax
2 balances and deferred DSM costs. These assets were created only as a result of explicit
3 Commission orders providing for the cost deferral and a mechanism for its recovery. These
4 would be valued a book value and recovered in a transition charge.

5 **The APS Pseudo Net-Revenues-Lost Method.** Although Citizens does not support
6 the net-revenues-lost method, if it is used it must be used correctly. The method set out in
7 the Working Group Report calculates stranded assets as the net present value of future
8 annual differences in revenues under continued regulation, versus the amounts likely to be
9 realized after the introduction of competition, using an appropriate discount rate. The
10 important point is that the calculation must include all future annual differences. Otherwise,
11 the results could end up biased one way or another. Further, the results should be subject
12 to periodic true-ups as actual costs are learned.

13 APS purports to support the net-revenues-lost method but would distort it beyond
14 recognition. As set forth by Mr. Davis (Exhibit APS-8, pp. 8-9, Schedule JED-1), APS would
15 ignore all future revenues after the year 2006. This would allow APS to recover all above-
16 market costs between now and the year 2006 and then keep all below-market costs after
17 that date. Further, APS' proposal would just about guarantee that competitors will be kept
18 out of its service territory.

19 APS' ignoring of the years after 2006 would leave it in a formidable competitive
20 position. APS' current embedded generation cost is above the market price of electricity, but
21 is declining. (Tr. XII, p. 3703). In contrast, market prices are rising, and are expected to
22 reach long-run marginal cost by the end of 2006. (*Id.* at 3702). If these trends continue,
23 after 2006 APS' embedded generation cost will be below market price and the cost to

1 construct new generating capacity (the long-run marginal cost). This means that APS would,
2 without further obligation for repayment, own generation that is already one of the lowest
3 marginal-cost producers in the Western United States. (*Id.*, at 3798). Its embedded costs,
4 by then priced below market price, should continue to decline as it is further depreciated.
5 Finally, its treasury would have been enriched by collection of eight years of pseudo
6 stranded costs from its customers.

7 In the mean time, APS would have been isolated from competition by its proposal.
8 Each customer that left the system would each year have to pay back to APS the difference
9 between APS production costs and the California Power Exchange wholesale price. (Ex.
10 APS-8, Schedule JED-1). Unless the customer could buy for less than the wholesale price,
11 it would do no better than break even compared to staying with APS. And if the customer
12 could not purchase for less than wholesale price (certainly the likely scenario), the customer
13 that left APS for a competitor would actually be worse off. As a consequence, APS' proposal
14 would almost guarantee that it would lose no customers to competition before 2007, at which
15 time it would be one of the lowest cost producers in the Western United States.

16 Citizens certainly supports recovery of bona-fide stranded costs that result from the
17 transition to competition, but it cannot endorse APS' proposal. Auction and divestiture would
18 let the market value generation assets over their entire lives, not just the near future. As
19 previously discussed, auction and divestiture would avoid the problems inherent in even a
20 fair net-revenues-lost method, such as the need for lengthy proceedings and future true-ups.
21 And auction and divestiture would certainly prevent APS from being unjustly enriched at its
22 customers' expense and thwarting competition.

1 The Commission should reject APS' self-serving, pseudo net-revenues lost method.
2 It would prevent competition in APS' service territory for the next eight years, enrich APS at
3 the expense of its customers and leave APS in perhaps the strongest competitive position in
4 the United States.

5 **COMMISSION QUESTION NUMBER 3A**

6 **WHAT IS THE RECOMMENDED CALCULATION METHODOLOGY, AND WHAT**
7 **ASSUMPTIONS ARE MADE, INCLUDING DETERMINATION OF MARKET**
8 **CLEARING PRICE?**
9

10 In response to and in consideration of the testimony presented in the recently
11 completed hearings, Citizens has modified its auction and divestiture proposal as follows:-

12 The calculation and recovery of stranded cost associated with generation resources
13 would proceed as follows:

- 14
15 1. Each Affected Utility will identify which specific generation resources, or
16 portions of the capacity of specific resources, are used solely for the purpose of
17 system support. Each Affected Utility shall include in its Stranded Cost Filing
18 ("SCF") the level of costs associated with the identified system support
19 resources and a rationale for the allocation of these costs between regulated
20 transmission and distribution functions. The remaining generation resources
21 are the Potentially Strandable Generation ("PSG").
22
- 23 2. Each Affected Utility must take reasonable efforts to mitigate the total costs of
24 its PSG. In its SCF each Affected Utility will describe all mitigation measures it
25 has taken, the results of these measures, and explain measures considered
26 but rejected. Mitigation measures will be reported for the period of January 1,
27 1996, to the date of filing of the SCF. Each Affected Utility is accorded the
28 rebuttable presumption that all unmitigated strandable costs will be considered
29 for recovery. Any party opposing full recovery has the burden of proof that the
30 Affected Utility did not take reasonable mitigation efforts.
31
- 32 3. Each Affected Utility will include in its SCF an estimate of the stranded cost
33 associated with its entire PSG portfolio using a Net Revenues Lost or
34 Replacement Cost Valuation methodology. The Affected Utility will support its
35 choice and calculation assumptions within the SCF hearing process.
36

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4. In its SCF the Affected Utility will elect whether it will proceed with an Auction and Divestiture stranded cost valuation process or use an Administrative valuation approach consistent with its selected stranded cost calculation methodology.
 5. An Affected Utility electing Auction and Divestiture must include its entire PSG portfolio in the auction process. Its SCF will describe how the auction will meet the requirements of:
 - using an experienced outside party to conduct the auction;
 - maximizing bidder participation;
 - ensuring ample information is made available to enable informed bids; and
 - minimizing the cost of conducting the auction process.

16 The Commission will approve proposed auction processes that meet these
17 requirements.

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6. Unregulated affiliates of an Affected Utility may bid for assets under guidelines submitted to and approved by the Commission.
 7. For PSG divested through an approved auction process, the Commission will establish a recovery charge and recovery period which allow a reasonable opportunity for full recovery of the strandable costs determined through the auction.
 8. To encourage divestiture of PSG in a manner that achieves the highest possible proceeds, the Commission will allow Affected Utilities to retain a share of any reductions in strandable costs resulting from the auction and divestiture. The reduction will be the difference between the estimate of strandable costs as approved in the SCF proceedings and the stranded costs determined through the auction and divestiture. An Affected Utility will be allowed to recover up to 50% of the reductions achieved through the auction and divestiture, as determined by the Commission. Recovery of the Affected Utility's share will be effected by increasing the stranded cost recovery charge by the Commission-approved amount above the actual level of stranded costs determined through the CAP.
 9. An Affected Utility that elects administrative valuation for its PSG will be allowed a reasonable opportunity to recover strandable costs under the following conditions:
 - Recovery charges will be subject to annual administrative true-ups; filings will be made on the anniversary date of the SCF. The SCF must propose the format of such true-up filings and proceedings.

- 1 • The maximum level of stranded cost recovery will be the level estimated
- 2 in the SCF; the actual amount of stranded cost recoverable may be
- 3 subject to downward adjustment in true-up proceedings.
- 4 • To compensate for the increased administrative costs associated with
- 5 the administrative valuation proceedings, an Affected Utility's costs
- 6 incurred for true-up filings and proceedings will not be recoverable
- 7 through regulated rates;
- 8 • The recovery period for stranded cost recovery will be limited to no more
- 9 than 5 years;
- 10 • The actual stranded cost recovery charge will be established such that
- 11 total electric costs do not exceed regulated rate levels at the time of the
- 12 SCF.
- 13

14 **COMMISSION QUESTION NUMBER 3B**

15 **WHAT ARE THE IMPLICATIONS OF SFAS NO. 71 RESULTING FROM THE**

16 **RECOMMENDED STRANDED COST CALCULATION AND RECOVERY**

17 **METHODOLOGY?**

18

19 With respect to generation-related assets, an auction and divestiture approach can

20 effectively avoid the potentially onerous financial issues raised by the Statement of Financial

21 Accounting Standards (SFAS) No. 71 (and the related statements, SFAS 101 and 121) in

22 association with the valuation and recovery of stranded costs. This is so because divestiture

23 avoids the need for utilities to continue to carry above-market generation assets on their

24 books. When utilities face the loss of their categorization as a "regulated enterprise" as a

25 result of the deregulation of the electric industry, they are faced with writing off all regulatory

26 assets and liabilities (under SFAS 101). To the extent a utility retains above-market

27 generation based on a regulatory order stating it is entitled to recover the above-market

28 portion through rates, its financial future is predicated upon a regulatory asset. Under

29 Citizens' approach, that regulated utility would have divested its interest in the generation

30 assets (at book value), so the issue becomes moot.

1 **COMMISSION QUESTION NUMBER FOUR**

2 **SHOULD THERE BE A LIMITATION ON THE TIME FRAME OVER WHICH**
3 **STRANDED COSTS ARE CALCULATED?¹¹**
4

5 Citizens does not support a limitation on the time frame over which stranded costs are
6 calculated. The time frame over which stranded costs are calculated must be consistent with
7 the remaining service lives for generation assets, the remaining contract term for purchased
8 power contracts, and the remaining amortization period for regulatory assets to allow for full
9 recovery of stranded costs. Anything short of this would result in denial of full stranded cost
10 recovery. On this issue, Citizens concurs with the findings in the report of the Stranded Cost
11 Working Group.

12 **COMMISSION QUESTION NUMBER FIVE**

13 **SHOULD THERE BE A LIMITATION ON THE RECOVERY TIME FRAME FOR**
14 **STRANDED COSTS?¹²**
15

16 Citizens does support a limitation on the period over which stranded costs are
17 recovered. But a time frame for recovery can only be established by balancing the goals of
18 achieving the shortest possible recovery period and minimizing the impact on rates. Citizens
19 does not support arbitrarily setting a recovery time frame without considering the magnitude
20 of the resulting economic impacts. Under administrative approaches with true-up
21 mechanisms, it would be impossible to establish up-front a time frame that balances these
22 goals because the full extent of stranded costs would not be known. However, under
23 Citizens' approach, where stranded costs are determined up-front with finality, it would be

¹¹ Unless otherwise indicated, this section of the brief is based upon the testimony of Citizens witness Sean Breen. (Ex. Cit-1, Cit-2).

¹² Unless otherwise indicated, this section of the brief is based upon the testimony of Citizens witness Sean Breen. (Ex. Cit-1, Cit-2).

1 possible to calculate the rate impact as a function of time frame and make a reasoned
2 decision about the appropriate length of the recovery period.

3 **COMMISSION QUESTION NUMBER SIX**

4 **HOW AND WHO SHOULD PAY FOR STRANDED COSTS AND WHO, IF ANYONE,
5 SHOULD BE EXCLUDED FROM PAYING STRANDED COSTS?¹³**
6

7 Citizens generally supports the consensus position of the Stranded Cost Working
8 Group that all customers should pay for stranded costs and that the charge to standard offer
9 customers should account for contributions that are already being made toward stranded
10 costs. However, the Rules' Competitive Phases create a significant equity issue. The
11 Competitive Phases included in the current Rule will create two classes of customers: those
12 who can choose their supplier and those who can not. It would not be equitable to charge
13 stranded cost fees to customers who can not participate in the competitive market. Citizens
14 agrees with the argument that recovering stranded costs from all customers will shorten the
15 needed recovery time frame – a desirable outcome. This is all the more reason for
16 eliminating Competitive Phases in favor of a "flash-cut" to open competition at a later date,
17 after matters are resolved and adequate preparations are made.

18 Stranded costs should be recovered through a non-bypassable charge levied by the
19 LDC that remains regulated, using a flat monthly charge (i.e. not tied to kWh or kW
20 consumption) based on historic usage levels. Thus, for example, residential customers
21 using 0 to 5000 kWh/year would pay, say \$5/month, while customers who historically have
22 used 5001 to 10,000 kWh/year would pay \$10/month, etc. Flat charges for stranded costs

¹³ Unless otherwise indicated, this section of the brief is based upon the testimony of Citizens witness Sean Breen. (Ex. Cit-1, Cit-2).

1 would be the least distorting because they would not affect the marginal cost for electricity
2 and, therefore, consumption or production decisions.

3 All customers served by the LDC of Affected Utilities should pay for costs stranded by
4 the restructuring of the industry. None should be excluded.

5 **COMMISSION QUESTION NUMBER SEVEN**

6 **SHOULD THERE BE A TRUE-UP MECHANISM AND, IF SO, HOW WOULD IT**
7 **OPERATE?¹⁴**

8
9 No true-up mechanism is needed under the Auction and divestiture method.

10 Stranded costs are determined at the outset of competition and no further adjustments are
11 made. The true-up mechanisms envisioned under administrative approaches will inevitably
12 trigger contentious litigation and in effectively prolong the regulation of power supply.

13 **COMMISSION QUESTION NUMBER EIGHT**

14 **SHOULD THERE BE PRICE CAPS OR A RATE FREEZE IMPOSED AS A PART OF**
15 **THE DEVELOPMENT OF A STRANDED COST RECOVERY PROGRAM AND IF**
16 **SO, HOW SHOULD IT BE CALCULATED?¹⁵**
17

18 Citizens opposes any price cap or rate freeze that results in a *de facto* disallowance
19 of unmitigated stranded costs. Utilities must be provided a reasonable opportunity for full
20 recovery of unmitigated stranded costs.

¹⁴ Unless otherwise indicated, this section of the brief is based upon the testimony of Citizens witness Sean Breen. (Ex. Cit-1, Cit-2).

¹⁵ Unless otherwise indicated, this section of the brief is based upon the testimony of Citizens witness Sean Breen. (Ex. Cit-1, Cit-2).

1 **COMMISSION QUESTION NUMBER NINE**

2 **WHAT FACTORS SHOULD BE CONSIDERED FOR MITIGATION OF STRANDED**
3 **COSTS?¹⁶**

4
5 It is impossible to create a finite list of "every feasible, cost-effective measure" that
6 utilities must take to mitigate stranded costs. The ability to mitigate stranded costs depends
7 entirely on the particular circumstances of each utility. It is improbable that a list of every
8 possible option that addresses the individual circumstances of each utility could be
9 reasonably prepared. For instance, in the case of utilities, like Citizens, with strandable long-
10 term purchased power agreements, no one could list every conceivable negotiating strategy
11 or option that may be used to re-negotiate agreements.

12 The current standard in the Rule states that the "Affected Utilities shall take every
13 feasible, cost-effective measure to mitigate or offset Stranded Costs." The standard that
14 every measure be taken is not achievable. It would always be possible to demonstrate a
15 new "twist" that was not pursued. Instead, because the Commission has found that the
16 existing investments or costs are reasonable for setting utility rates, the burden of proof for
17 non-recovery of these costs must be placed on the party that is recommending the non-
18 recovery. While Affected Utilities should be required to vigorously pursue reasonable means
19 to mitigate stranded costs, as a result of the regulatory compact, the Affected Utilities must
20 be given the starting point that unmitigated amounts are recoverable. That is, unmitigated
21 stranded costs would be deemed fully recoverable unless a party could demonstrate the
22 Affected Utility did not make reasonable mitigation efforts.

¹⁶ Unless otherwise indicated, this section of the brief is based upon the testimony of Citizens witness Sean Breen. (Ex. Cit-1, Cit-2).

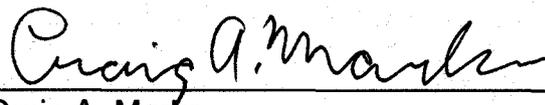
1 To allow the Commission to judge the reasonableness of mitigation efforts, each
2 Affected Utility should make a showing of all mitigation measures it has taken, the results of
3 those measures, and an explanation of measures considered but rejected. The burden of
4 proof that the Affected Utility in fact did not make adequate mitigation efforts would then fall
5 on the party seeking denial of full recovery of the stated level of unmitigated stranded costs.
6 The Commission should judge the reasonableness of a utility's mitigation efforts by the
7 weight of the evidence that there are additional mitigation measures that could have been
8 reasonably implemented, and/or that the utility failed to fully pursue the measures it selected.

9 The party seeking denial must be prepared to show that the actions it proposes had a
10 reasonable chance of succeeding and would have resulted in greater mitigation than
11 achieved by the Affected Utility. It is not sufficient for a party to simply identify a possible
12 mitigation alternative not taken as the basis for denial of recovery. It must also prove that
13 the alternative could be reasonably implemented.

14 Turning to the considerations contained in the Rules under R14-2-1607(I), the
15 Commission cannot properly employ these considerations to limit, or in effect "mitigate" the
16 magnitude of stranded costs that are recoverable by Affected Utilities. This would cause
17 confiscatory earnings levels, if it employed any of the listed considerations in determining the

1 amount of stranded costs that would not be recoverable by an Affected Utility. Certain of
2 these considerations could properly be employed to determine the design of the stranded
3 cost recovery mechanism, but not the total amount recoverable.

4 RESPECTFULLY SUBMITTED this 16th day of March, 1998.

5
6 

7
8 Craig A. Marks
9 Associate General Counsel
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15 Original and ten copies of the foregoing
16 filed this March 16, 1998, with:

17
18 Docket Control Division
19 Arizona Corporation Commission
20 1200 West Washington Street
21 Phoenix, Arizona 85007
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23 Copies of the foregoing mailed or hand
24 delivered this March 16, 1998, to:

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27 Chief Hearing Officer
28 Arizona Corporation Commission
29 1200 West Washington Street
30 Phoenix, Arizona 85007
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32 Paul Bullis
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34 Arizona Corporation Commission
35 1200 West Washington Street
36 Phoenix, Arizona 85007
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38 Ray Williamson
39 Acting Director, Utilities Division
40 Arizona Corporation Commission
41 1200 West Washington Street
42 Phoenix, Arizona 85007
43

44 All Parties indicated on Service List
45

46
47 By 
48 Joann Zychlewicz

EXHIBIT A

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF HAWAII

In the Matter of the Application of)
CITIZENS UTILITIES COMPANY,)
KAUAI ELECTRIC DIVISION)
For Approval of Rate Increase and)
Revised Rate Schedules and Rules.)

DOCKET NO. 94-0097

In the Matter of the Application of)
CITIZENS UTILITIES COMPANY,)
KAUAI ELECTRIC DIVISION)
For Approval of Statewide Surcharge)
to Recover Repair and Restoration)
Costs Resulting From Hurricane)
Iniki.)

DOCKET NO. 94-0308

(CONSOLIDATED)

DECISION AND ORDER NO. 14859

ATTEST: A True Copy
BERTHA F. KUROSAWA
Chief Clerk, Public Utilities
Commission, State of Hawaii.

Bertha F. Kurosawa

Filed August 7, 1996
At 2:35 o'clock P.M.

Bertha F. Kurosawa
Chief Clerk of the Commission

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF HAWAII

In the Matter of the Application of)
CITIZENS UTILITIES COMPANY,)
KAUAI ELECTRIC DIVISION)
For Approval of Rate Increase and)
Revised Rate Schedules and Rules.)

Docket No. 94-0097

In the Matter of the Application of)
CITIZENS UTILITIES COMPANY,)
KAUAI ELECTRIC DIVISION)
For Approval of Statewide Surcharge)
to Recover Repair and Restoration)
Costs Resulting From Hurricane)
Iniki.)

Docket No. 94-0308

(Consolidated)

Decision and Order No. 14859

DECISION AND ORDER

I.

INTRODUCTION

On July 21, 1994, KAUAI ELECTRIC DIVISION (KE) OF CITIZENS UTILITIES COMPANY (Citizens) filed an application for approval of a rate increase, revised rate schedules, and tariff rule changes in Docket No. 94-0097. In its application, KE sought approval of a general rate increase of \$23,657,544 in additional revenues for test year 1995, aimed largely at recovering expenses resulting from the destruction of plant and equipment by Hurricane Iniki in 1992.¹

¹On October 21, 1992, KE filed an application seeking to defer a new rate case by instituting certain accounting practice modifications, such as deferring earnings on restoration investment, and deferring recovery of Hurricane Iniki-related

KE served copies of its application on the Division of Consumer Advocacy, Department of Commerce and Consumer Affairs (Consumer Advocate) and Mayor Joann Yukimura. Pursuant to Hawaii Revised Statutes (HRS) § 269-16, which requires that the commission hold a public hearing on an application for a rate increase upon notice as provided in HRS § 269-12, the commission held a public hearing on KE's application on September 22, 1994, at Wilcox Elementary School in Lihue, Kauai.

On September 6, 1994, the United States Department of Defense (the DOD), through the Department of the Navy, filed a timely motion to intervene in Docket No. 94-0097. On October 3, 1994, the County of Kauai (Kauai County); Vernelle Aguiar, Donna Kamaunu and Carla Akau, by their attorney the Legal Aid Society of Hawaii (Legal Aid); Clara Fraticelli, Tomasa Acoba, Bonifacio Acoba, Daniel Johnson, Mabel Branco and Ernest Branco, by their attorney the Seniors' Law Program (Seniors' Law Program); and Loka Partners also filed timely motions to intervene.

By Order No. 13596, filed on October 13, 1994, the commission took the following action in Docket No. 94-0097: (1) the Consumer Advocate was made a party; (2) the DOD and Kauai County were made intervenors; (3) Legal Aid and the

expenses. On November 25, 1992, the parties filed a stipulation agreeing to such modifications. The deferred amounts would be recovered in KE's next rate case, which KE agreed would not be filed until 1994. The commission approved the stipulation on December 9, 1992.

Seniors' Law Program were made participants²; and (4) Loka Partners was denied intervention.

On October 24, 1994, KE filed an application for approval of a statewide surcharge to recover repair and restoration costs resulting from Hurricane Iniki (statewide surcharge application). KE served copies of its statewide surcharge application on the Consumer Advocate, Mayor Joann Yukimura, each of the intervenors and participants in Docket No. 94-0097, Hawaiian Electric Company, Inc. (HECO), Maui Electric Company, Limited (MECO), and Hawaii Electric Light Company, Inc. (HELCO). In its statewide surcharge application, which was docketed as Docket No. 94-0308, KE requested that the commission consolidate Docket No. 94-0308 with Docket No. 94-0097.

By Order No. 13649, filed on November 18, 1994, the commission granted KE's motion to consolidate Docket No. 94-0308 with Docket No. 94-0097. All parties in Docket No. 94-0097 (whose scope of participation had not been limited in that docket) were made parties in consolidated Dockets No. 94-0097 and No. 94-0308. The order also instructed the parties to meet informally to formulate a stipulated prehearing order for submission to the commission for approval within two weeks.

On November 28, 1994, Legal Aid and the Seniors' Law Program filed separate motions to intervene in Docket No. 94-0308. By Order No. 13667, filed on December 7, 1994, the commission

²Legal Aid's and the Seniors' Law Program's participation in this docket was limited to the issue of the specific impact of KE's proposed rate increase on its low-income ratepayers and senior citizen ratepayers.

denied their motion, but allowed Legal Aid and the Seniors' Law Program to participate without intervention in the statewide surcharge portion of the consolidated dockets.³ The order also extended the deadline to December 12, 1994, for the parties to submit a stipulated prehearing order to the commission for approval. On January 6, 1995, the commission approved Stipulated Prehearing Order No. 13719, which set forth the issues and procedural schedule in the consolidated dockets.

The Consumer Advocate and the DOD filed their direct testimonies, exhibits, and workpapers on February 28, 1995. Kauai County filed its direct testimonies and exhibits on March 3 and 14, 1995. Legal Aid filed its direct testimonies and exhibits on March 10 and 13, 1995. The Seniors' Law Program filed its direct testimonies and exhibits on March 13, 1995. KE filed its rebuttal testimonies on March 28, and April 10 and 13, 1995. The Consumer Advocate and KE each supplemented and corrected portions of their testimonies, exhibits, and workpapers prior to the scheduled evidentiary hearing.

In its rebuttal testimonies, filed on March 28, 1995, KE indicated that it had adopted or moved towards many of the Consumer Advocate's and the DOD's positions regarding non-Iniki expense and rate base items. Thus, KE revised its estimate of

³Legal Aid's and the Seniors' Law Program's participation in the statewide surcharge portion of the consolidated dockets was limited to the issue of the specific impact of the denial of KE's proposed statewide surcharge in conjunction with the approval of KE's proposed rate increase on its low-income ratepayers and senior citizen ratepayers.

additional revenue requirement from \$23,657,544 to \$19,000,000 for test year 1995.

The commission held the evidentiary hearing in these consolidated dockets on April 24, 25, 26, and 28, and May 1, 2, 3, 4, 8, and 15, 1995. During the evidentiary hearing, KE revised its additional revenue requirement for test year 1995 to \$19,153,000. On the last day of the evidentiary hearing, KE, the Consumer Advocate, the DOD, and Kauai County presented oral argument with respect to their positions on the interim and final rates, considering the impact with and without the statewide surcharge.

By Interim Decision and Order No. 13949, filed on June 9, 1995, the commission granted KE an interim rate increase to produce, in the aggregate, \$5,983,000 in additional revenues for test year 1995, effective June 15, 1995. The commission, however, reserved to the final decision and order a determination of the issues concerning the imposition of a statewide surcharge, and the recovery of Hurricane Iniki restoration and repair costs.

On July 27, 1995, Kauai County filed its opening brief. On July 28, 1995, KE and the DOD filed their opening briefs. On August 2, 1995, the Consumer Advocate, Legal Aid, and the Seniors' Law Program filed their opening briefs. On August 21, 1995, KE, the Consumer Advocate, the DOD, and Kauai County filed their reply briefs. On August 22, 1995, Legal Aid filed its reply brief.

This final decision and order addresses KE's request for a permanent rate increase, including, among other things, the imposition of a statewide surcharge, and the recovery of Hurricane Iniki restoration and repair costs.

II.

KE'S REVENUE INCREASE REQUEST

In its Docket No. 94-0097 application, KE sought approval of a general rate increase in the amount of \$23,657,544 in additional revenues for test year 1995. This proposed increase represented an increase of 36.2 per cent over present rates. This estimate of KE's revenue requirement would have produced a rate of return of 10 per cent on KE's average adjusted rate base of \$162,446,543 for test year 1995. To ease the burden of a 36.2 per cent rate increase on its ratepayers, KE proposed to implement the total increase of \$23,657,544 in three steps. The first step was to take effect on May 1, 1995, and would have allowed KE to recover \$9,965,988 in additional revenues. The second step was to take effect on September 1, 1995, and would have allowed KE to recover \$7,129,841 in additional revenues. The last step was to take effect on April 1, 1996, and would have allowed KE to recover \$6,561,715 in additional revenues.

KE now maintains that its additional revenue requirement for test year 1995 is \$19,153,000, or an increase of 33.07 per cent over present rates. This revised estimate of KE's revenue requirement would produce a rate of return of 10 per cent on its revised average adjusted rate base of \$157,924,000 for test year 1995. As in its original application, KE proposes to implement the increase of \$19,153,000 in three steps. The first step was to take effect on June 1, 1995, and would have allowed KE to recover interim rate relief of \$9,846,000 in additional revenues. The second step was to take effect on September 1, 1995, and would have allowed KE to recover \$7,048,000 in additional revenues. The last

step was to take effect on April 1, 1996, and would have allowed KE to recover \$2,259,000 in additional revenues.

The Consumer Advocate proposes an increase of \$5,434,000 in additional revenues, resulting in a total revenue requirement of \$64,304,000. The Consumer Advocate calculated a rate of return of 9.10 per cent on KE's revised average adjusted rate base of \$123,049,000 for test year 1995.

The DOD proposes an increase of \$9,212,000 in total additional revenues, resulting in a total revenue requirement of \$68,082,000. The DOD calculated a rate of return of 9.7 per cent on KE's revised average adjusted rate base of \$125,606,000 for test year 1995.

Kauai County sought the minimum rate increase possible, but did not propose specific amounts for KE's additional revenue requirement, rate of return, or rate base. Kauai County advocates that the commission approve no more than a five or six per cent increase over present rates.

III.

ISSUES

Stipulated Prehearing Order No. 13719 sets forth the following issues in this docket:

1. Whether the proposed general rate increase is just and reasonable. Included within this issue are the following sub-issues:
 - a. Whether the revenue forecasts for the test year under present and proposed rates are reasonable;
 - b. Whether the projected operating expenses for the test year are reasonable;

- c. Whether the properties included in rate base are actually used or useful for public utility purposes, and whether the projected rate base for the test year is reasonable;
 - d. Whether the requested rate of return is fair and reasonable; and
 - e. Whether the proposed tariffs, rates, charges, and rules are just and reasonable, and not unduly discriminatory.
2. What is the amount of the interim rate increase, if any, to which KE is entitled to under HRS § 269-16(b).⁴
 3. To what extent is it just, reasonable, and in the public interest for Applicant's ratepayers or its shareholders, or both, to bear part or all of the net restoration and repair costs⁵ incurred to restore facilities damaged by Hurricane Iniki to a functional level substantially the same as that existing immediately before Hurricane Iniki.
 4. To the extent it is just, reasonable, and in the public interest for Applicant's ratepayers to bear part or all of such net restoration and repair costs, whether Applicant's calculation and estimate of the net restoration and repair costs to be borne by its ratepayers is reasonable, and would result in a rate increase of more than fifteen per cent for the average residential ratepayer in Applicant's service territory.
 5. To the extent the Commission determines it is just, reasonable, and in the public interest for Applicant or another utility acting on behalf of Applicant to implement a monthly surcharge on all ratepayers statewide for the type of service rendered by Applicant:
 - a. Which ratepayers should be excluded from the surcharge because their rates are substantially higher than other utility service territories in the state;

⁴This issue is now moot. By Interim Decision and Order No. 13949, the commission granted KE an interim rate increase of \$5,983,000 in additional revenues for test year 1995, effective June 15, 1995.

⁵The term "net restoration and repair costs" is defined by statute and will be discussed in the following section of this decision and order.

- b. What is the appropriate period that the surcharge should be assessed; and
- c. Whether Applicant's proposed methodologies to be used to assess the surcharge and calculate the monthly recurring charge are reasonable.

IV.

THE STATEWIDE SURCHARGE UNDER ACT 337

KE seeks commission approval to implement a statewide surcharge to recover its restoration and repair costs resulting from Hurricane Iniki. Because the statewide surcharge, if approved, would reduce the overall revenue requirement sought by KE, we address this issue first.

KE makes its request for a statewide surcharge pursuant to Act 337, Session Laws of Hawaii 1993, which is now codified as HRS § 269-16.3. Act 337 was enacted in response to Hurricane Iniki, a natural disaster that caused severe damage on the island of Kauai in 1992, but left the rest of the State relatively unharmed. Act 337 provides statewide assistance to an affected utility in any specific region of the State that sustains damages from a natural disaster in a State-declared emergency more harshly than other areas (affected utility). As stated in Act 337, its purpose is to more equitably distribute utility restoration and repair costs incurred as a result of a State-declared emergency.

Act 337 provides for the recovery by an affected utility of the costs of restoration and repair of facilities damaged in a State-declared emergency. The affected utility would recover its net restoration and repair costs through a statewide surcharge paid by ratepayers on other islands having utility services similar to those rendered by the affected utility. The statewide surcharge

would help mitigate the impact of huge rate increases on the affected utility's ratepayers.

For a statewide surcharge to take effect, the affected utility must demonstrate that, without the surcharge, the net restoration and repair costs to be borne by its ratepayers would result in a rate increase of more than 15 per cent for the average residential ratepayer in the affected service territory. Under the Act, the commission, upon a determination that the application is just, reasonable, and in the public interest, must:

- (1) Decide the extent to which it is just, reasonable, and in the public interest for the damaged utility's ratepayers or shareholders, or both, to bear part or all of the restoration and repair costs;
- (2) Determine whether the amount of any net restoration and repair costs to be borne by the ratepayers of the damaged utility would result in a rate increase of more than fifteen per cent for the average residential ratepayer in that utility's service territory;
- (3) Issue an order allowing the affected utility or another utility acting on behalf of the affected utility to implement a monthly surcharge on all ratepayers statewide for the type of service rendered by the affected utility if the public utilities commission determines pursuant to paragraph (2) that a rate increase of more than fifteen per cent would otherwise be assessed;
- (4) Exclude from any such order ratepayers in utility service territories with rates that are substantially higher than other utility service territories in the State; and
- (5) Periodically review the order to ensure that the amounts collected by, or on behalf of, the utility shall not exceed the amount determined by the public utilities commission to be the net restoration and repair costs actually incurred.

HRS § 269-16.3(c).

A. Shareholder Versus Ratepayer Responsibility

Under Act 337, the commission must first decide the extent to which it is just, reasonable, and in the public interest for KE's ratepayers or Citizens' shareholders,⁶ or both, to bear part or all of the Iniki restoration and repair costs.

The Consumer Advocate would have Citizens' shareholders bear the entire costs of Iniki restoration and repair.⁷ In the alternative, the Consumer Advocate proposes that Citizens' shareholders bear no less than 50 per cent of the restoration and repair costs. The DOD recommends that Iniki restoration and repair costs be shared equally and equitably between KE's ratepayers and Citizens' shareholders. Both the Consumer Advocate and the DOD argue that Act 337 authorizes this commission to impose a portion or all of the Iniki restoration and repair costs on Citizens' shareholders.

KE's position is that full recovery of Iniki restoration and repair costs from its ratepayers should be permitted. KE contends that the Consumer Advocate's and the DOD's positions are unsupported by law or public policy. To the contrary, KE states that there are overwhelming legal and policy reasons for allowing KE's prudent investment in Iniki restoration-related used and useful assets dedicated to public service. KE enumerates the following legal and policy reasons:

⁶We note that KE is a division and not a subsidiary corporation of Citizens. Thus, for purposes of Act 337, we balance the interests between KE's ratepayers and Citizens' shareholders with respect to who should bear the Iniki restoration and repair costs.

⁷This sentiment was echoed by KE's ratepayers during the public hearing in this proceeding.

1. Citizens' shareholders have already suffered significant losses as a result of Hurricane Iniki that will never be recovered from its ratepayers.

2. The stipulation entered into by KE, the Consumer Advocate, and the DOD in Docket No. 7517, and approved by the commission in Decision and Order No. 12064, allows challenges to Iniki restoration investment only on the basis of prudence.

3. The historic "regulatory compact" for the past 100 years between a utility and its regulators supports the inclusion of Iniki restoration plant in rate base. Citizens should not be at risk from recovering its Iniki investment because it relied on this regulatory compact in voluntarily providing disaster recovery support.

4. Disallowance of Iniki restoration investment and extraordinary storm expenses would cause the required rate of return on equity for KE and other Hawaii utilities to escalate because of increased risk to investors.

5. KE's decision to self-insure its transmission and distribution plant has benefitted ratepayers through lower rates in the past. Thus, recovery of Iniki restoration costs should be borne by the same ratepayers who benefitted from self-insurance.

6. KE's utility services cannot be compared to an unregulated business in a competitive market because, among other reasons, such unregulated businesses do not have a duty to serve their customers.

As pointed out by the Consumer Advocate and the DOD, by Act 337, the legislature has charged this commission with the authority to balance the interests between the utility's ratepayers

and its shareholders with respect to who should bear the Iniki restoration and repair costs. After considerable review, consideration, and balancing of these interests, we do not find it just, reasonable, or in the public interest to require Citizens' shareholders to bear any of the Iniki restoration and repair costs.

Our decision is based in a large part on the long-standing regulatory compact. The regulatory compact has two aspects: (1) in return for a monopoly franchise, utilities accept the obligation to serve all comers; and (2) in return for agreeing to commit capital necessary to allow the utilities to meet the obligation, utilities are assured a fair opportunity to earn a reasonable return on the capital prudently committed to the business. In Wash. Util. and Trans. Comm'n v. Puget Sound Power & Light Co., 62 P.U.R.45th 557, 581 (1984), the Washington Commission explained the regulatory compact in this fashion:

The social and economic compact of utility regulation begins with the premise that a regulated utility has an obligation to serve the public. [A] utility possesses an unending obligation to provide service to anyone within the service territory of that utility who demands service in accordance with approved tariffs.

However, in order for the social duty to serve to be viable, the compact must also provide for a utility to recover expenses it prudently undertakes to meet the obligation. (Emphasis original.)

This regulatory compact has been recognized in this⁸ and other jurisdictions⁹ in the regulatory treatment accorded extraordinary storm losses and expenses in the past. In light of Citizens' (through KE) duty to serve and to make prudent investments to meet its obligation, it was expected that Citizens would quickly restore and repair its damaged facilities immediately after Iniki. Indeed, conscious of its obligation and relying on past regulatory practice that recognized the regulatory compact, Citizens voluntarily and expeditiously provided Iniki restoration and recovery support to the island of Kauai. It would be fundamentally unfair to change the regulatory rules after a disaster has occurred and restoration efforts have been completed by Citizens. It would be unjust and unreasonable to disallow Citizens an opportunity to earn a return on its prudent investment in used and useful property. See Duquesne Light Co. v. Barasch, 488 U.S., 299 (1989) (the Constitution protects utilities from being limited to a return for their property serving the public which is so unjust as to be confiscatory). Thus, it is just and reasonable that we adhere to past regulatory treatment of extraordinary storm damages and expenses and allow Citizens to recover prudently incurred Iniki-related investment.

The Consumer Advocate argues that the commission should decide this issue in a manner that emulates a competitive market.

⁸See, e.g., In re Hilo Elec. Light Co., Ltd., Docket No. 1462, Decision and Order No. 1065 (1961).

⁹See, e.g., Re Kansas City Power & Light Co., 75 P.U.R.4th 1 (1986); Narragansett Elec. Co. v. Burke, 415 A.2d 177, 37 P.U.R.4th 569 (1980); Wisconsin's Environmental Decade, Inc. v. Pub. Serv. Comm'n of Wis., 298 N.W.2d 205 (1980).

In a competitive market, the Consumer Advocate asserts that businesses must sustain the losses resulting from a natural disaster. By emulating such a market, the Consumer Advocate contends that Citizens' shareholders should be held responsible for any Iniki-related losses.

We find that KE's duty to serve the public precludes any comparisons of KE to an unregulated business in a competitive market. In a competitive market, a business must first decide whether to restore or to cease operations. It will cease operations if it determines that it will not be able to recoup its restoration costs and remain competitive with its competitors. If it restores operations, the business will attempt to recover its restoration expenses by increasing either prices or the volume of business. On the other hand, as a regulated utility, KE has a duty to restore service as quickly as possible. It has no option to cease operations. Furthermore, KE cannot increase its rates without commission authorization, which entails a lengthy rate case proceeding where the Consumer Advocate and other interested parties have an opportunity to scrutinize and evaluate KE's rate increase request for reasonableness.

The Consumer Advocate also contends that Citizens' shareholders should bear the Iniki-related restoration and repair costs due to "excess earnings" by the shareholders in the past. The Consumer Advocate performed a market-to-book analysis on Citizens, and discovered that the company enjoyed extremely high market-to-book ratios for at least 25 years. Based on Citizens' historically high market-to-book ratios, the Consumer Advocate states that the company received excess earnings by collecting more

than its cost of capital. Thus, the Consumer Advocate concludes that it would be fair and equitable for Citizens' shareholders to pay for all Iniki-related restoration and repair costs.

We decline to adopt this novel theory as applied by the Consumer Advocate to the recoverability of KE's prudently incurred, used and useful capital investment. It would set a dangerous precedent to limit a utility's return on prudently incurred, used and useful property based on the utility's market-to-book ratio. The Consumer Advocate has failed to point to any jurisdiction that has adopted this approach. The fact that the market-to-book ratio approach does not distinguish between a utility's regulated and unregulated businesses is also troubling. Finally, we question whether a high market-to-book ratio indeed suggests excess earnings.

Thus, based on the above, we conclude that it is just, reasonable, and in the public interest for KE's ratepayers to bear the Iniki-related restoration and repair costs prudently incurred by Citizens.¹⁰ We next address whether the amount of the net restoration and repair costs to be borne by KE's ratepayers would result in a rate increase of more than 15 per cent for the average residential ratepayer as required by Act 337.

¹⁰We note, however, that the issues associated with the establishment of a self-insurance reserve are currently being examined by this commission in Docket No. 95-0051.

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2
3 JIM IRVIN
4 COMMISSIONER--CHAIRMAN
5 RENZ D. JENNINGS
6 COMMISSIONER
7 CARL J. KUNASEK
8 COMMISSIONER
9

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10 IN THE MATTER OF THE COMPETITION) DOCKET NO. RE-00000C-94-0165
11 IN THE PROVISIONS OF ELECTRIC)
12 SERVICES THROUGHOUT THE STATE)
13 OF ARIZONA.)
14 _____)

15
16 **CITIZENS UTILITIES COMPANY'S**
17 **LEGAL MEMORANDUM**
18 **IN SUPPORT OF INITIAL BRIEF**
19

20 **I. The Regulatory Compact Is Real And Cannot Be Unilaterally**
21 **Disavowed**
22

23 In Decision No. 59943, the Commission recognized that stranded costs arise from the
24 profound regulatory changes required to move the electric utility industry from a system of
25 regulated monopolies to a more competitive market, and that utilities should be allowed to
26 recover costs incurred in reliance on the continuation of the previous regulatory system. This
27 opportunity for stranded cost recovery arises from the fact that Arizona utilities, like utilities
28 throughout the United States, are charged with the monopoly obligation to serve all
29 customers within a defined service area and are restricted in the rates they may charge for
30 their service. In turn, utility rates allow a reasonable return on and of utility investments
31 made in order to meet the obligation to serve. This obligation to serve coupled with a right to
32 a reasonable return comprises the regulatory compact that is at the heart of government
33 regulation of public utilities.

1 The regulatory compact is not some recent invention, as some have maintained. The
2 notion of a regulatory compact has been at the heart of the relationship between regulated
3 industries and their regulators for well over 100 years. Sidak & Spulber, *Deregulatory*
4 *Takings and Breach of the Regulatory Compact*, 71 N.Y.U.L. Rev. 851, 890-906 (1996).

5 The regulatory compact is fundamental to, and is as old as, rate regulation. In 1885,
6 the United States Supreme Court in *New Orleans Water-Works Co. v. Rivers*, 1115 U.S. 674
7 (1885), defined the regulatory compact granted to a utility as follows:

8 The right to dig up and use the streets and alleys of New Orleans for the
9 purpose of placing pipes and mains to supply the city and its inhabitants
10 with water is a franchise belonging to the State, which she could grant to
11 such persons or corporations, and upon such terms, as she deemed
12 best for the public interests Such was the nature of plaintiff's grant,
13 which, not being at the time prohibited by the constitution of the State,
14 *was a contract, the obligation of which cannot be impaired by*
15 *subsequent legislation, or by a change in her organic law. It is as much*
16 *a contract, within the meaning of the Constitution of the United States,*
17 *as a grant to a private corporation for valuable consideration*
18 (Emphasis added.)
19

20 The Supreme Court confirmed the contractual relationship between a state and a
21 public utility a few years later in *Walla Walla City v. Walla Walla Water Co.*, 172 U.S. 1, 9
22 (1898), wherein it held that:

23 The grant of a right of way to supply gas or water to a municipality and
24 its inhabitants through pipes and mains laid in the streets, upon condition
25 of the performance of its service by the grantee, is the grant of a
26 franchise vested in the State, in consideration of the performance of a
27 public service, and after performance by the grantee, *is a contract*
28 *protected by the Constitution of the United States against state*
29 *legislation to impair it.* (Emphasis added.)
30

31 More recently, Judge (now Justice) Scalia explained, "the very nature of government
32 rate regulation" is "a compact whereby the utility surrenders its freedom to charge what the

1 market will bear in exchange for the state's assurance of adequate profits." *New England*
2 *Coalition on Nuclear Pollution v. Nuclear Regulatory Comm'n*, 727 F.2d 1127, 1130 (D.C. Cir.
3 1984).

4 In *In re Trico Electric Co-operative, Inc.*, 92 Ariz. 373, 377 P.2d 309 (Ariz. 1962), the
5 Arizona Supreme Court discussed the regulatory compact:

6 In the performance of its duties with respect to public service
7 corporations the Commission acts as an agency of the State. By the
8 issuance of a certificate of convenience and necessity to a public service
9 corporation the State in effect contracts that if the certificate holder will
10 make adequate investments and render competent and adequate
11 service, he may have the privilege of a monopoly as against any other
12 private utility.

13 *Id.* at 315.

14 This obligation to serve exists in tandem with a utility's right to charge rates that permit
15 recovery of the costs of service and a reasonable rate of return. See A.R.S. § 40-361(A).
16 See also Ariz. Const. at Article 15, Section 3 (enumerating powers of Commission). The
17 courts have consistently held that just and reasonable rates shall provide utilities with the
18 opportunity to recover their costs and to earn a return on their investment. See, e.g.,
19 *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307, 314 (1989); *Bluefield Waterworks &*
20 *Improvement Co. v. Public Service Comm'n of W. Virginia*, 262 U.S. 679, 692-93 (1923);
21 *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 153, 294 P.2d 378, 383 (Ariz.
22 1956); *Scates v. Arizona Corporation Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15
23 (Ariz. App. 1978).

24 The rules would violate this regulatory compact to the extent that they put utilities at
25 risk to underrecover stranded costs. In reliance on the continuing obligation to serve,
26 Citizens, like other utilities, made investments in physical assets and entered into long-term

1 contracts with wholesale power suppliers in order to continue to meet its public service
2 obligations. Investors were willing to underwrite these long-term investments in reliance
3 upon the existing regulatory regime which provided Citizens the ability to recover its costs,
4 and earn a reasonable return on its investment, through the collection of Commission-
5 prescribed just and reasonable rates. A change in regulatory policy that has the effect of
6 preventing Citizens from recovering the costs it incurred in reliance on the continuation of the
7 pre-existing regulatory policy would violate this long-standing regulatory compact.

8 In recognition of the investments made by public utilities in reliance upon the
9 continuation of the regulatory compact, abrupt changes in regulatory policy have been found
10 to violate the regulatory compact. The violation requires that the affected entity be
11 compensated for its resulting injury. In *United States v. Winstar Corp.*, 116 S. Ct. 2432; 135
12 L Ed 2d 964 (1996) (plurality), the Supreme Court held that the government was responsible
13 financially to a regulated business for the economic injury that resulted from a change in
14 regulatory policy. The decision in *Winstar* concerned the impact of changes in federal
15 legislation governing the accounting treatment for so-called "regulatory goodwill." The
16 changes had the effect of reducing the book value of institutions that had acquired ailing thrift
17 institutions in reliance on the prior policy to a level that rendered many of them insolvent or in
18 violation of regulatory capital requirements. The Court examined the nature of the
19 relationship between the regulated entities and the regulatory authority and concluded:

20 [I]t would have been irrational in this case for [the institution] to stake its
21 very existence upon continuation of current policies without seeking to
22 embody those policies in some sort of contractual commitment. This
23 conclusion is obvious from both the dollar amounts at stake and the
24 regulators' proven propensity to make changes in the relevant
25 requirements. . . . Under the circumstances, we have no doubt that the
26 parties intended to settle regulatory treatment of these transactions as a

1 condition of their agreement. See, e.g., *The Binghamton Bridge*, 3 Wall.
2 51, 78 (1866) (refusing to construe charter in such a way that it would
3 have been 'madness' for private party to enter into it).

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

10 Parties have argued that the regulatory compact does not exist because it is not set
11 out in a specific writing. This is a fundamental misunderstanding of contract law. Contracts
12 need not be in writing to be enforceable. The Commission's obligation to honor its regulatory
13 commitments is derived from the relationship between the regulatory authority and the
14 regulated entity. It is not grounded on a specific instrument or contractual commitment. See,
15 e.g., *Winstar*, 116 S. Ct at 2452 (agreements to provide particular regulatory treatment "are
16 especially appropriate in the world of regulated industries, where the risk that legal change
17 will prevent the bargained-for performance is always lurking in the shadows"). Justice Scalia,
18 in his concurring opinion, stated this point even more directly:

19 [The parties seeking to enforce the regulatory compact allege] that the
20 government *promised* to regulate them in a particular fashion, into the
21 future. They say that the very *subject matter* of these agreements, an
22 essential part of the *quid pro quo*, was government regulation; unless the
23 Government is bound *as to that regulation*, an aspect of the transactions
24 that reasonably must be viewed as a *sin qua non* of their asset becomes
25 illusory. I think they are correct. If . . . the Government committed only
26 "to provide [certain regulatory] treatment unless and until there is
27 subsequent action," . . . then the Government in effect said "we promise
28 to regulate in this fashion for as long as we choose to regulate in this
29 fashion" -- which is an absolutely classic description of an illusory
30 promise. . . . In these circumstances, it is unmistakably clear that the
31 promise to accord favorable regulatory treatment must be understood as

1 (unsurprisingly) a *promise* to accord favorable regulatory treatment. I do
2 not accept that unmistakability demands that there be a *further* promise
3 not to go back on the promise to accord favorable regulatory treatment.
4

5 *Id.* at 2477 (citations omitted; emphasis in original).
6

7 Citizens and other Affected Utilities made capital investments and entered into long-
8 term power purchase contracts based on the regulatory assurance that their prudent
9 investments would be recoverable through rates. *Detroit v. Detroit Citizens' Street Railway*
10 *Co.*, 184 U.S. 368, 385 (1902) ("It would hardly be credible that capitalists about to invest
11 money in what was then a somewhat uncertain venture, . . . would at the same time . . . give
12 the right to the [government] to change at its pleasure from time to time those important and
13 fundamental rights affecting the very existence and financial success of the company").
14 Having ordered or sanctioned substantial investments by utilities upon the understanding that
15 such investments would be recoverable through rates, it would be unreasonable and
16 unlawful for the Commission to repudiate its obligation to provide the utilities a reasonable
17 opportunity to recoup the costs of such investments and/or contractual commitments.

18 Parties have also argued that, absent a clear indication that the legislature intends to
19 be bound, there is no regulatory compact, *citing National Railroad Passenger Corp. v.*
20 *Atchison, Topeka and Santa Fe Railroad Co.*, 470 U.S. 451 (1985) (Explanatory Statement
21 at 35-36). This argument is without merit. In *National Railroad*, a group of railroads
22 challenged on due process grounds an amendment to the Rail Passenger Service Act which
23 required the railroads to reimburse Amtrak for the cost of certain passenger services. The
24 railroads contended that the Act constituted a binding contract between the United States
25 and the railroads and that the amendment therefore impaired an obligation of the United
26 States under that contract. In that case, the Supreme Court held that the Act did not

1 constitute a contract and denied the railroads' claim. Unlike *National Railroad*, Citizens does
2 not assert that the Commission is barred by a regulatory compact from implementing the
3 amended rule. Rather, Citizens' position is simply that it should be provided a reasonable
4 opportunity to recover stranded costs that result from Commission actions that change the
5 existing regulatory regime. Denial of that opportunity would violate the regulatory compact.

6 In other forums parties have argued, based upon legal theories governing contracts of
7 indefinite term, that the regulatory compact is unenforceable. In fact, cases that concern
8 utility franchise areas hold otherwise. In *James P. Paul Water Co. v. Ariz. Corp. Comm'n*,
9 137 Ariz. 426, 671 P.2d 404 (Ariz. 1983), the Arizona Supreme Court explained that
10 certificates of convenience and necessity issued by the Commission are intended to continue
11 for as long as the certificate holder continues to provide the relevant service at a reasonable
12 rate:

13 Once granted, the certificate confers upon its holder an exclusive right to
14 provide the relevant service for as long as the grantee can provide adequate
15 service at a reasonable rate. If a certificate of convenience and necessity
16 within our system of regulated monopoly means anything, it means that its
17 holder has the right to an opportunity to adequately provide the service it was
18 certified to provide. Only upon a showing that a certificate holder, presented
19 with a demand for service which is reasonable in light of projected need, has
20 failed to supply such service at a reasonable cost to customers, can the
21 Commission alter its certificate. Only then would it be in the public interest to
22 do so.

23
24 *Id.* at 407 (footnote omitted). The Court noted that "[a] system which did not provide
25 certificate holders with an opportunity to provide adequate service at reasonable rates before
26 deletion of a certificated area could be made would be antithetical to the public interest. . . ."

27 *Id.*

1 It is important to note that the regulatory compact does not hold that regulators may
2 not change existing regulations. Nor does the regulatory compact invoke notions of estoppel
3 to foreclose action by the Commission. Rather, compliance with the regulatory compact
4 requires that the rules adopted to implement the Commission's policy changes provide
5 regulated utilities the continuing opportunity to recover costs incurred in compliance with the
6 prior regulatory regime.

7 Finally, Citizens does not contend -- and has not argued -- that the regulatory compact
8 prevents the Commission from implementing competition. What Citizens has established is
9 that a change in regulatory policy would violate this long-standing regulatory compact if it has
10 the effect of preventing Citizens from recovering the costs it incurred in reliance on the
11 continuation of the pre-existing regulatory policy.

12 **II. Affected Utilities Must Be Given a Reasonable Opportunity to**
13 **Recover Costs Stranded By The Commission's Move to Competition.**

14 It is well established that property rights of regulated utilities enjoy constitutional
15 protection. *Atlantic Coast Line R.R. v. North Carolina Corp. Comm'n*, 206 U.S. 1, 20 (1907).
16 The Fifth Amendment's takings clause specifies that the government cannot "forc[e] some
17 people alone to bear public burdens which, in all fairness and justice, should be borne by the
18 public as a whole." *Dolan v. City of Tigard*, 114 S. Ct. 2309, 2316 (1994) (quoting *Armstrong*
19 *v. United States*, 364 U.S. 40, 49 (1960)). As a result, a Commission order denying Citizens
20 a continuing opportunity to recover its stranded costs would constitute an uncompensated
21 taking of private property in violation of the Fifth Amendment and Article II, Sections 4, 17 of
22 the Arizona Constitution.
23

1 **A. The Implementation Of Competition Without A Reasonable**
2 **Opportunity For Full Stranded Cost Recovery Would Constitute**
3 **An Unconstitutional Regulatory Taking.**
4

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

12 In *Penn Central Transportation Co. v. New York City*, 438 U.S. 104 (1978), the
13 Supreme Court, applying precedent dating back to *Pennsylvania Coal Co. v. Mahon*, 260
14 U.S. 393 (1922), explained that government decisions that interfere with a property interest
15 constitute a taking under the Fifth Amendment. *Penn Central* set out three factors to be
16 considered to determine whether regulation "goes too far" and constitutes a taking: (a) the
17 character of the government action: (b) the economic impact of the regulation: and (c) the
18 extent to which the regulation interferes with investment-backed expectations. When these
19 factors are applied to the present case, it is clear that any disallowance of stranded costs
20 would constitute a taking.

21 First, the character of the government action -- the pervasive regulatory changes
22 designed to transform the electric utility industry from a system of regulated monopolies to a
23 competitive market -- should not override utility investors' interest in continuing recovery of
24 costs incurred in order to meet the utilities public service obligations. This factor requires a

1 balancing of the purpose and importance of the regulatory imposition with the competing
2 private property interests. *Loveladies Harbor, Inc. v. United States*, 28 F.3d 1171, 1176
3 (Fed. Cir. 1994). This analysis also looks to whether the means selected for obtaining the
4 regulatory goal were reasonably designed to attain it. *Id.*

5 Less than full recovery of stranded costs would not bear a reasonable relation to the
6 state's interest in promoting competition for energy services. The costs that would be
7 rendered stranded as a result of the regulatory changes imposed by the Commission are
8 costs that were incurred by Citizens as part of its public service obligations. There is no
9 reasonable basis for concluding that the Commission's decision to promote competition
10 requires the disallowance of costs prudently incurred to provide service at rates previously
11 held to be just and reasonable. In fact, although retail electric competition should ultimately
12 provide benefits even to residential customers, there is hardly any public clamor for electric
13 competition.

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

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

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

8 The compensation which the Constitution guarantees an opportunity to
9 earn is the reasonable cost of conducting the business. Cost includes
10 not only operating expenses, but also capital charges. Capital charges
11 cover the allowance, by way of interest, for the use of capital, whatever
12 the nature of the security issued therefore; the allowance for risk
13 incurred; and enough more to attract capital. *Id.* at 291 (Brandeis, J.,
14 concurring). The Commission's failure to allow for full stranded cost
15 recovery plainly impairs these reasonable, investment-backed
16 expectations.²

¹ Debt and equity securities issued by a public utility are investments in the same manner as comparable securities issued by any other business. See *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) ("the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks."). As a result, if the return to utility investors falls below the return available from other investments with equivalent risks, investors will shift their capital to earn the greater return.

² A utility with an allowed rate of return equal to only its cost of capital has not been compensated for bearing the risks of stranded costs, and so cannot be made to bear them without denying the utility "a return on the value of property which it employs . . . equal to that generally being made . . . on investments in other businesses which are attended by corresponding risks and uncertainties." *Bluefield Waterworks & Improvement Co. v. Public Serv. Comm'n*, 262 U.S. 678, 692 (1923). A sharing of stranded costs is appropriate only if there has been adequate advance compensation for the risk that such sharing would be required. Citizens, however, has received no such compensation. Nor has it seen evidence that other utilities, inside or outside Arizona, have received such compensation.

1 When the *Penn Central* factors are considered together, it is clear that, to the extent
2 that the Commission mandates retail competition yet disallows an Affected Utility's full
3 recovery of its stranded costs, any such underrecovery would constitute an impermissible
4 regulatory taking of the utilities' property.

5 **B. The Implementation Of Competition Without A Reasonable**
6 **Opportunity For Full Stranded Cost Recovery Would Result In**
7 **Confiscatory Rates.**

8
9 It is well-established that the United States Constitution both provides utilities with the
10 right to a reasonable opportunity to recover -- and earn a reasonable return upon -- their
11 prudent investments and prohibits state regulators from establishing rates at a level that
12 would be confiscatory. *See, e.g., Duquesne Light Co. v. Barasch*, 488 U.S. 299, 307, 314
13 (1989). This precedent also holds that just and reasonable rates fall within a range of
14 permissible rates which balances investor and ratepayer interests. *See, e.g., In re Permian*
15 *Basin Area Rate Cases*, 390 U.S. 747, 767 (1968); *Federal Power Comm'n v. Hope Natural*
16 *Gas Co.*, 320 U.S. 591, 603 (1944); *Federal Power Comm'n v. Natural Gas Pipeline Co.*, 315
17 U.S. 575, 585 (1942). Rates which fall below a just and reasonable level are confiscatory
18 and in violation of the Takings Clause of the Fifth and Fourteenth Amendments. *See, e.g.,*
19 *Duquense, supra*, at 307-8 (rate is confiscatory where it is "so unjust as to destroy the value
20 of [the utility] property for all the purposes for which it was acquired.") (citing *Covington &*
21 *Lexington Turnpike Road Co. v. Sanford*, 164 U.S. 578, 597 (1896)).

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

1 The [allowed rate of] return should be reasonably sufficient to assure
2 confidence in the financial soundness of the utility and should be
3 adequate, under efficient economical management, to maintain and
4 support its credit and enable it to raise the money necessary for the
5 proper discharge of its public duties.
6

7 *Id.* at 692-93.
8

9 The Court elaborated on the standard to be applied to provide the constitutional
10 protection of investor interests in *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S.
11 591, 603 (1944):

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

21 *Id.* at 603.
22

23 In Arizona, the Commission is charged with establishing just and reasonable rates,
24 and in so doing will apply the general principle that the revenues derived from such rates "be
25 sufficient to meet a utility's operating costs and to give the utility and its stockholders a
26 reasonable rate of return on the utility's investment." *Simms v. Round Valley Light & Power*
27 *Co.*, 80 Ariz. 145, 153, 294 P.2d 378, 383 (Ariz. 1956); *Scates v. Arizona Corporation*
28 *Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (Ariz. App. 1978). The starting point
29 for a determination of just and reasonable rates is the assessment of the fair value of the
30 utility's property, which is used as the utility's rate base. Ariz. Const. Art. 15. The
31 Commission must then apply a reasonable rate of return to this rate base to set a just and

1 reasonable rate. *Arizona Corporation Comm'n v. Arizona Public Service Co.*, 113 Ariz. 368,
2 370, 555 P.2d 326, 328 (Ariz. 1976).

3 The move to a more competitive marketplace for energy services -- without a
4 reasonable opportunity to recover fully the stranded costs that flow from the move -- would
5 put utilities at risk for underrecovery of their costs of service and would deny them the ability
6 to earn a return on their investment. The adoption of rates that fall short of these
7 constitutional requirements would confiscate the utilities' property.

8 The Constitutions of the United States and the State of Arizona prevent the
9 Commission from "forcing [Citizens and other Affected Utilities] alone to bear public burdens
10 which, in all fairness and justice, should be borne by the public as a whole." *Dolan v. Tigard*,
11 114 S. Ct. 2309, 2316 (1994). By restructuring the electric industry and sticking the utilities
12 with the bill, the Commission would do just that. Such regulatory opportunism would be
13 unlawful and unreasonable.

14 **III. The Commission Must Allow Recovery Of Any Stranded Costs**
15 **Associated With Wholesale Power Purchase Contracts.**

16
17 Citizens has only limited generation assets and must rely primarily on purchased
18 power contracts to meet its energy and capacity requirements. Each wholesale power
19 contracts to which Citizens is a party is subject to federal regulation and priced at rates
20 approved by the Federal Energy Regulatory Commission ("FERC"). See, e.g., *Federal*
21 *Power Comm'n v. Southern California Edison Co.*, 376 U.S. 205, 210-12 (1964). Under the
22 "filed rate doctrine" the Arizona Commission has no jurisdiction over such sales or the rates
23 paid by Citizens or other Affected Utilities that purchase power at wholesale in the interstate
24 market. See, e.g., *State of Utah v. FERC*, 691 F.2d 444, 446-48 (10th Cir. 1982). This

1 preemptive authority is derived from the Federal Power Act, which states that the FERC shall
2 determine whether electric wholesale rates are just and reasonable, and from the Supremacy
3 Clause, which invalidates all state laws that conflict or interfere with an act of Congress.
4 See *Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 963-64 (1986); *Arkansas*
5 *Louisiana Gas Co. v. Hall*, 453 U.S. 571, 581-82 (1981).

6 The Supreme Court first established the filed rate doctrine in *Montana-Dakota Utilities*
7 *Co. v. Northwestern Public Service Co.*, 341 U.S. 246 (1951). In that case, petitioner alleged
8 that the rates approved by the Federal Power Commission ("FPC")³ were unreasonably high
9 due to allegedly fraudulent conduct by an interlocking directorship and asked a federal court
10 to apply a different rate to award damages. The Court applied principles of primary
11 jurisdiction to conclude that the rate filed with and approved by the FPC is the only legitimate
12 or reasonable rate and that a court is without jurisdiction to apply a different rate. *Id.* at 251-
13 52. The Court refined this holding in *Arkansas Louisiana Gas Co. v. Hall*, 453 U.S. 571
14 (1981), to rely expressly on preemption grounds. There, a seller of natural gas urged a state
15 court to utilize a contract rate that exceeded the filed rate to calculate damages. The Court
16 held that a state court may not substitute its judgment for the FERC's, and could not apply a
17 rate other than the rates on file with or approved by the FERC. *Id.* at 581-82.

18 In a decision that is highly instructive on this issue, *Nantahala Power & Light Co. v.*
19 *Thornburg*, 476 U.S. 953 (1986), the Supreme Court addressed the impact of the FERC's
20 wholesale rate determination on state ratemaking authority. In *Nantahala*, the Court held
21 that state regulatory commissions must allow for full recovery through retail rates of costs

³ The FERC's predecessor agency.

1 incurred by the payment of FERC-approved wholesale rates. Under this holding, the
2 preemptive effect attaches not only to wholesale rates, but to all other FERC decisions
3 "affect[ing] those rates." *Id.* at 966-67. Applying *Nantahala*, courts have held that state
4 commissions may not question or alter the wholesale rates determined by FERC and may
5 not bar local distribution companies from passing such costs through to local ratepayers.
6 See, e.g., *Mississippi Power & Light Co. v. Moore*, 487 U.S. 354, 372 (1988); *Kentucky West*
7 *Virginia Gas Co. v. Pennsylvania Public Utility Comm'n*, 837 F.2d 600, 609, (3rd Cir.), *cert*
8 *denied*, 488 U.S. 941 (1988).

9 The filed rate doctrine, which operates independently of the constitutional prohibitions
10 against uncompensated takings discussed above, requires the Commission to enable
11 Citizens and other comparable Affected Utilities to continue to recover through retail rates the
12 costs of wholesale power purchase contracts. As a result, any approach to stranded cost
13 recovery that would deny Citizens' full recovery of these costs will be invalid.

14 There are two exceptions to the filed-rate doctrine, neither of which applies to Citizens.
15 The first is the so-called *Pike County* exception, after *Pike County Light & Power Co. v.*
16 *Penn. Pub. Util. Comm'n*, 465 A.2d 735 (1983). It allows a State Commission to evaluate a
17 wholesale purchase for prudence in light of other supply alternatives that may have been
18 available. This exception cannot come into play because the Commission has already found
19 Citizens' wholesale power purchases to be prudent and has included the costs for pass-
20 through in Citizens' purchased power and fuel adjustment clause. The second exception is
21 drawn from *Nantahala, supra*. It would allow a Commission to reduce retail rates even in the
22 face of a wholesale price increase, if other costs had declined to a greater extent. No party
23 has suggested that this is the case, so this exception is also not relevant.

1 **IV. The Commission Cannot Require An Affected Utility To Utilize**
2 **Revenues From Collateral Services To Offset Stranded Costs.**
3

4 A.A.C. R14-2-1607(A) states that "Affected Utilities shall take every feasible, cost-
5 effective measure to mitigate or offset Stranded Costs by means such as expanding
6 wholesale or retail markets, or offering a wider scope of services for profit, among others."
7 While Citizens agrees that utilities should act in a reasonable manner to mitigate stranded
8 costs, there is a critical distinction between mitigation and the use of revenues from collateral
9 services to reduce -- or "offset" the stranded costs a utility may seek to recover. The
10 concept of mitigation of damages is a basic principle of contract law. In general, it means that
11 an injured party may not unreasonably fail to act, thereby allowing its damages to
12 accumulate, and then seek to recover the damages that could have been avoided. See, e.g.,
13 McCormick, Handbook on the Law of Damages § 33 at 127 (1935). Professor Corbin has
14 explained:

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

26
27 A. Corbin, Corbin on Contracts § 1039 at 242-3 (1964). Thus, with regard to stranded costs,
28 the application of a mitigation theory would deny a utility recovery of stranded costs where it
29 could be shown that the costs could have been avoided but for the utility's unreasonable acts

1 or omissions. Citizens concurs with the Commission that utilities should take all reasonable
2 efforts to mitigate avoidable stranded costs.

3 The rules' reference to offset, however, would apply a very different approach. While
4 mitigation is designed to encourage cost avoidance, offset is designed to reduce cost
5 responsibility. Offset is comparable to the remedies of recoupment and counterclaim, and,
6 like such remedies, is based on the presence of opposing -- or offsetting -- claims between
7 two parties. See, e.g., *WJ. Kroeger Co. V. Travelers Indem. Co.*, 112 Ariz. 285, 287-88, 541
8 P.2d 385, 387-88 (Ariz. 1975); *Egan-Ryan Mechanical Co. V. Cardon Meadows*
9 *Development Corp.*, 169 Ariz. 161, 170-71, 818 P.2d 146,156 (Ariz. App. 1990); *Morris v.*
10 *Achen Construction Co., Inc.*, 155 Ariz. 507, 509-10, 747 P.2d 1206, 1208-09 (Ariz. App.
11 1986), *aff'd in part and rev'd in part on other grounds*, 155 Ariz. 512, 747 P.2d 1211 (Ariz.
12 1987). Offset is used to reduce a prevailing party's award by the amount of a claim owed by
13 it to the opposing party. The responsibility for stranded costs, however, does not fit into this
14 claim/counterclaim approach because utilities' stranded costs are the result of legal and
15 regulatory changes. There are no offsetting claims by the Commission or ratepayers.
16 Accordingly, there is no legal basis for the Commission to order offset (as opposed to
17 mitigation) of stranded costs.

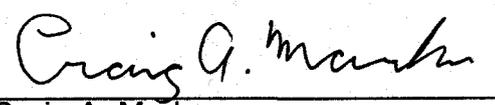
18 It would only compound the error if the Commission were to mandate that utilities
19 offset stranded costs by "expanding wholesale or retail markets" and "offering a wider scope
20 of services for profit". At law, both the doctrines of mitigation and offset are distinguished
21 from collateral source payments. These are payments from other sources, independent of
22 and collateral to the breaching party, that are received by the injured party. Collateral source
23 payments are not to be used to diminish the injured party's damages. See, e.g., *Folkstead v.*

1 *Burlington Northern, Inc.* 813 F.2d 1377, 1380-81 (9th Cir. 1987); *Russo v. Matson*
2 *Navigation Co.*, 486 F.2d 1018,1020 (9th Cir. 1973). For example, where a seller of goods
3 sells multiple items, the damages from a breach of contract are not mitigated by other sales
4 that would ordinarily occur in the normal course of business. Citizens would be denied a
5 reasonable opportunity to recover its stranded costs, if collateral revenues derived from other
6 aspects of Affected Utilities' operations were used to reduce the level of stranded costs that
7 would otherwise be eligible for recovery.

8 In addition, should Citizens expand its market or offer new services for profit it may do
9 so in areas that are geographically or substantively beyond the Commission's jurisdiction.
10 While examples abound, Citizens may elect to offer electric utility service in adjoining states,
11 may develop new products or services in Arizona that are not regulated by the Commission
12 in the competitive market, or may enter into business activities that are unrelated to the
13 provision of utility service. Under the rules, the revenues derived from these sources would
14 be used as an offset to stranded costs even though the activities are unrelated to the
15 incurrence of the stranded costs and are not within the scope of the Commission's
16 jurisdiction. The rules unreasonably encumber these opportunities by mandating that the
17 revenues derived from such new services be diverted to offset stranded costs. As Citizens
18 has shown, the Commission may not mandate a standard or create an administrative
19 procedure that serves to deny utilities a reasonable opportunity to recover stranded costs. A
20 requirement that utilities utilize collateral source revenues to offset such costs would deny
21 such necessary opportunity for stranded cost recovery and would, therefore, be unlawful and
22 invalid.

1 Finally, these new investments may be made based on the opportunities available in
2 the competitive market for such new services, one in which non-utility entrants will be
3 competing with utilities for customers and investors. Affected Utilities that must offset
4 stranded costs against revenues would be unable to compete effectively against these new
5 market entrants that are not burdened with stranded cost recovery. There is no credible
6 basis for the Commission to encumber these at-risk investments by mandating that the
7 revenues derived from such new services be diverted to offset stranded costs.

8 RESPECTFULLY SUBMITTED this 16th day of March, 1998.

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