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BEFORE THE ARIZONA COURT OF APPEALS, CIVIL DIVISION
AZ CORP COMMISSION

DOCKETED

JIM IRVIN
COMMISSIONER-CHAIRMAN
RENZ D. JENNINGS
COMMISSIONER
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COMMISSIONER

MAR 16 1998

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

DOCKET NO. RE-00000C-94-0165
RUCO'S INITIAL BRIEF

The Residential Utility Consumer Office ("RUCO") hereby submits its initial brief in the stranded cost portion of the above-referenced Docket.

I. INTRODUCTION

Electric service is a necessity that is critical to the well being of the citizens of Arizona. It is clear that the restructuring of the electric industry to allow for retail competition will have a direct impact on the residential electric customers throughout the state. The position of RUCO regarding the transition to competition has remained constant: "Do no harm."

RUCO supports competition because RUCO believes that pressure from a truly competitive marketplace will result in beneficial technological innovations and more efficient generating plant operations. Genuine competition will allow residential customers to enjoy long term price benefits and a wider choice of available services. RUCO is not alone in this belief; a number of parties have expressed similar views.¹

However, some witnesses have indicated that the picture may not be rosy for residential consumers in a deregulated environment. There was testimony that although residential customers may be offered marketing "deals" for generation initially, consumer prices in the long run are unknown and unpredictable; the cost of capital for the riskier competitive business may

¹Dr. Rose (Staff), Transcript ("TR.") at 3089-3090, 3108-09; Mr. Breen (Citizens), TR. at 106-107, 123; Dr. Gordon (TEP), TR. at 714; Mr. Davis (APS), TR. at 3673; Dr. Rosenberg (Arizonans for Electric Choice), TR. at 2191-2192, 2217-18.

1 outweigh the cost savings of eliminating inefficiencies.² There was also testimony that when the
2 current excess capacity in the Western Grid diminishes, the cost for electricity will rise.³
3 Witnesses also testified that there will be no short-term benefits for residential customers, and
4 that it will take several years for real cost savings to develop.⁴ There were particular concerns
5 expressed regarding both low-income and rural residential customers.⁵ Testimony expressed
6 concern that without oversight, new market entrants might engage in price discrimination to the
7 disadvantage of small ratepayers.⁶

8 This testimony should raise a red flag for the Commission. It is crucial that the
9 Commission scrutinize the proposals offered in this docket, to determine how to implement all
10 phases of competition in a manner that protects the public interest and provides safeguards for
11 the small users, especially the residential consumer. Two former public utility commissioners,
12 former Chairman Fessler of California and former Commissioner Gordon (who served in both
13 Maine and Massachusetts), testified in this docket. Both emphasized that it is the Commission's
14 role to make these difficult decisions and to develop principles that will be in the best interest of
15 the state and its citizens.⁷

16 It is clear to RUCO that the restructuring of the electric industry involves risk for residential
17 customers. All the issues in the restructuring process must be handled in a manner consistent
18 with the public interest. Stranded cost, which is the difference between the competitive market
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20 ²Mr. Breen (Citizens), TR. at 123, 238-239; Mr. Fessler (TEP), TR. at 423.

21 ³Dr. Rosenberg (Arizonans for Electric Choice), TR. at 2215-2216; Mr. Davis (APS), TR. at 3702 (market
22 prices are currently below long run marginal cost).

23 ⁴Dr. Landon (APS), TR. at 2867-2870; Dr. Gordon (TEP), TR. at 691; Dr. Malko (Arizonans for Electric
24 Choice), TR. at 2132.

25 ⁵Mr. Minson (AEPSCO), TR. at 3050-3051; Ms. Firkins (IBEW), TR. at 324-325; Mr. Bayless (TEP), TR. at
26 1693, 1719-1721.

27 ⁶Dr. Coyle (City of Tucson), TR. at 1025.

28 ⁷Dr. Gordon (TEP), TR. at 704; Mr. Fessler (TEP), TR. at 486, 636-637.

1 value of retail generation services and the embedded cost of a utility's generation assets, is an
2 important issue for all parties. The determination of stranded cost recovery methodology and
3 mechanisms are arguably the most important hurdles that the Commission must clear to
4 implement a truly competitive generation market. The Commission's determination in this docket
5 will assuredly have far-reaching effects. Finding an equitable solution for the disposition of these
6 costs is crucial for the success of competition in Arizona. The interests of the incumbent utilities,
7 the new entrants and the public, particularly the residential customers, must be considered and
8 carefully balanced in order to provide for recovery of stranded costs that is just and reasonable,
9 and that will encourage a truly competitive market.

10 RUCO has developed an approach that would protect residential customers during the
11 transition to the competitive market. RUCO's proposal (discussed in detail below) advocates an
12 administrative valuation method to determine the amount of stranded costs for each utility. This
13 approach compares projections of the utility's revenue for electric generation if generation prices
14 were deregulated, and projections of the utility's revenues for electric generation if generation
15 prices continued to be regulated.

16 RUCO contends that a fundamentally important consideration in determining stranded cost
17 is the operational life of the generation assets. Virtually all methods proposed by the parties,
18 including divestiture and appraisal methodologies, factor in the operational life of the generating
19 asset when projecting its value. While RUCO strongly advocates assessing value over the
20 lifetime of the plant, this calculation period must be kept distinct from the recovery period of
21 stranded cost. RUCO proposes that any positive stranded costs should be collected as a non-
22 bypassable wires charge until competition is available to all customers, which is January 1, 2003,⁸
23 as currently mandated by the Commission's Retail Electric Competition Rules ("Rules").⁹
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26 ⁸A.A.C. R14-2-1604(D).

27 ⁹A.A.C. R14-2-1601 through R14-2-1616.

1 RUCO also proposes that the market price of power should be based on the average retail
2 cost of power in the region, because the cost of generation provided to retail customers includes
3 factors other than simply the wholesale cost of fuel. More accurately estimating the retail price
4 of generation services is important for calculating stranded costs, because the higher the retail
5 market price of electricity, the lower the Affected Utility's stranded cost will be.¹⁰ In other words,
6 use of the wholesale price rather than the retail price in calculating stranded cost would result in
7 an overestimation of those costs.¹¹ Additionally, because the determination of future market price
8 of power is speculative, RUCO's proposal includes a true-up mechanism, either on an annual or
9 bi-annual basis, to insure that stranded costs are neither overpaid nor underpaid.

10 RUCO is also proposing that the Commission implement a price cap during the transition
11 period to insure that residential consumers will not experience higher rates as a result of
12 competition. This is a safeguard that will ensure that no harm will be done to these consumers.¹²

13 As a matter of equity, RUCO is also recommending that there be a sharing of stranded
14 costs between the ratepayers and the shareholders of the utility company. Stranded costs are
15 a result of regulatory decisions made in a monopoly market; neither the ratepayers nor the
16 shareholders caused stranded costs. Furthermore, this sharing will provide an incentive for the
17 utilities to mitigate their stranded costs.¹³ The Commission's constitutional mandate to prescribe
18 rates that are just and reasonable¹⁴ should guide it in its determination of the proper proportional
19 sharing between shareholders and ratepayers.

22 ¹⁰See Mr. Davis (APS), TR. at 3810.

23 ¹¹Dr. Rosen (RUCO), TR. at 1844.

24 ¹²Dr. Rosenberg (Arizonans for Electric Choice), TR. at 2192.

25 ¹³Even APS' witness agreed that without a sharing of stranded costs, there would be no incentive to
26 mitigate. Dr. Hieronymus (APS), TR. at 2572.

27 ¹⁴Ariz. Const. art. 15, § 3.

1 The Affected Utilities have argued for the existence of an implied "regulatory compact" that
2 would prevent the Commission from implementing a stranded cost recovery mechanism resulting
3 in anything less than 100% recovery of the stranded costs they claim. They allege that this
4 purported "regulatory compact" derives from the Commission's issuance of a Certificate of
5 Convenience and Necessity ("CC&N") to the Affected Utilities. RUCO contends that no
6 "regulatory compact" exists that would require Arizona ratepayers to assure shareholders'
7 recovery of all uneconomic utility investments. The constitutional provision which granted the
8 Commission regulatory authority over public service corporations is silent as to any concepts of
9 "regulated monopoly."¹⁵

10 The CC&N's held by the Affected Utilities were granted by the Commission pursuant to
11 statute.¹⁶ Absent an expressed intent, courts will not construe a contractual obligation within a
12 regulatory statute. Laws are presumed not to create private contractual or vested rights, but only
13 to declare public policy.¹⁷ Arizona courts have repeatedly characterized regulated monopoly as
14 a public policy rather than as a contractual right.¹⁸ In fact, the existence of this alleged "compact"
15 has been litigated in the Arizona courts in the context of the Electric Competition Rules, and in
16 two separate decisions, courts have ruled against the Affected Utilities, finding that no regulatory
17 compact exists.¹⁹

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19 ¹⁵*Mountain States Tel. and Tel. v. Ariz. Corp. Comm'n*, 132 Ariz. 109, 114, 644 P.2d 263, 268 (App. 1982).

20 ¹⁶A.R.S. § 40-281. *See Williams v. Pipe Trades Indus. Prog. of Ariz.*, 100 Ariz. 14, 17, 409 P.2d 720, 722
21 (1966).

22 ¹⁷*Nat'l R.R. Passenger Corp. v. Atchison, Topeka, and Santa Fe Ry. Co.*, 470 U.S. 451, 465-466 (1985).

23 ¹⁸*See Ariz. Corp. Comm'n v. Super. Ct.*, 105 Ariz. 56, 59, 459 P.2d 489, 492 (1969)(referring to "regulated
24 "monopoly" as public policy); *Winslow Gas Co. v. Southern Union Gas Co.*, 76 Ariz. 383, 385, 265 P.2d 442, 443
25 (1954)(referring to "public policy of controlled monopoly"); *Pacific Greyhound Lines v. Sun Valley Bus Lines, Inc.*,
70 Ariz. 65, 71, 216 P.2d 404, 408 (1950)("The state's public policy respecting public service corporations is one of
regulated monopoly. . ."); *Corp. Comm'n v. Pacific Greyhound Lines*, 54 Ariz. 159, 177, 94 P.2d 443, 450
(1939)(public policy of regulated monopoly).

26 ¹⁹*Arizona Elec. Power Coop. v. Ariz. Corp. Comm'n*, No. CV 97-03920, CV 97-03921, CV 97-03922, CV 97-
27 03928, CV 97-03942 (consolidated). (Minute Entry of Jan. 16, 1998 at 9).("Plaintiffs present rights, represented by
CC&N's do not amount to vested contract or other property rights.") *Tucson Elec. Power Co. v. Ariz. Corp. Comm'n*,

1 **II. RUCO's PROPOSALS FOR STRANDED COSTS RECOVERY²⁰**

2 **A. Mitigation**

3 **[Issue 9: What factors should be considered for mitigation of stranded costs?]**

4 It is RUCO's position that utilities should be required to reduce potentially strandable
5 generation costs as much as possible before Arizona allows recovery of stranded costs. The
6 utilities should focus on bringing their embedded cost of generation (including operating costs)
7 closer to the market price for generation. Appropriate mitigation measures should involve cost
8 reductions.

9 There are numerous ways that utilities may mitigate stranded cost, including: restructuring
10 or refinancing existing debt; renegotiating or buying out purchase power contracts; selling excess
11 generation capacity if it has more value on the market than it does to the current owner; retiring
12 uneconomic generating facilities if their operating costs exceed the price of replacing their output;
13 and improving the economic efficiency and productivity of generation units.²¹

14 It is RUCO's position that neither cost shifting nor revenue enhancement through load
15 growth are true mitigation measures. Cost-shifting measures, such as voluntary write-downs of
16 excessive generating plant costs and accelerated depreciation schedules of plant or regulatory
17 assets, do not constitute genuine attempts at mitigating stranded costs. Instead, these measures
18 merely shift costs between utility shareholders and ratepayers, among customer classes, or
19 among electricity services, or they pose inter-generational equity problems.²²

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21
22 No. CV 97-03748 (Consolidated) (Minute Entry of Jan. 13, 1998 at 3) (" . . . TEP does not have a right to its
23 regulated monopoly in perpetuity; rather, TEP's CC&N can be amended, altered or revised through a section 40-
24 252 hearing to take away its exclusive right to generate electricity for its area.")

24 ²⁰The Hearing Officer has directed that the parties' briefs respond to the eleven issues set out in prior
25 Procedural Orders. To facilitate an organized discussion of RUCO's position, RUCO has reordered the questions.
26 The subheadings throughout the following discussion will identify the specific issues that the section discusses.

26 ²¹RUCO Exhibit 1 at 66-67 (Direct Testimony of Dr. Richard Rosen).

27 ²²Id. at 67; City of Tucson Exhibit 1 at 32 (Direct Testimony of Dr. Eugene P. Coyle).

1 **B. Stranded Cost Calculation Methodology**

2 **[Issue 3A: The recommended calculation method and assumptions made**
3 **including any determination of market clearing price.]**

4 **1. All Methodologies Require an Administrative Valuation.**

5 The parties have suggested a number of methodologies for calculating stranded cost,
6 including administrative valuation, market valuation, stock market valuation and assorted
7 modifications and hybrids of each of those methods. Most of the suggested methodologies,
8 including the market valuation method,²³ include an administrative valuation component. RUCO
9 contends that its administrative valuation methodology is the best means of balancing the
10 interests of the ratepayers, particularly the residential consumers, with the interests of
11 shareholders when calculating stranded cost.

12 Generally, using an administrative valuation approach, a utility's stranded generation cost
13 will initially be based on the difference between *projections* of the utility's revenues for electric
14 generation if generation prices were deregulated, and *projections* of the utility's revenues for
15 electric generation if generation prices continue to be regulated, based on the utility's current
16 embedded cost of generation.²⁴ Using a market valuation approach, a utility's stranded cost
17 would be based on the differences between the *actual* auction, sale, or spin-off price of each
18 utility's generation assets and the *actual* embedded costs of each utility's generation assets, net
19 of generation-related Administrative and General ("A&G") expenses, because they could be
20 avoided if divestiture occurs.²⁵ However, with the market valuation method, the Commission
21 would still need to use an administrative method to assure that the actual auction or sale prices

22 ²³Parties recommending market valuation relied on appraisal methods for those assets that were not sold.
23 Enron Exhibit 1 at 22 (Direct Testimony of Ms. Mona Petrochko); Electric Competition Coalition Exhibit 2 at 7 (Direct
24 Testimony of Dr. Douglas C. Nelson); PG&E Energy Services Exhibit 1 at 8 (Direct Testimony of Douglas A.
25 Oglesby).

26 ²⁴The "bottom up" approach recommended by some parties yields the same results as RUCO's
27 recommended "top-down" administrative valuation methodology. RUCO Exhibit 2 at 28; Dr. Rose (Staff), TR. at
28 3104.

²⁵RUCO Exhibit 1 at 19.

1 were reasonable.²⁶ The challenge with any of these methodologies is that future projections are
2 required to make a determination of the utility's estimated stranded cost. Therefore, the use of
3 a true-up mechanism is particularly important to ensure that ratepayers are not over- or under-
4 charged for stranded costs.

5 RUCO contends that there are fundamental problems with the stranded cost
6 methodologies proposed by other parties. These problems often derive from the fact that the
7 stranded costs would not be computed over a sufficiently long time frame to approximate the life
8 of the generating assets. Most egregious is the Arizona Public Service ("APS") proposal that
9 stranded costs only be computed on an annual basis during the period of "market imbalance"
10 prior to 2006.²⁷ This would clearly lead to the situation where most of the years of positive annual
11 stranded costs would be included in calculating the total stranded costs and most of the
12 subsequent years of negative stranded costs would be excluded. Implementation of APS'
13 proposal would automatically cause ratepayers to drastically overpay stranded costs without ever
14 receiving their share of the long run economic benefit of APS' plants. Similarly, even though the
15 Arizonans for Electric Choice proposed a significant sharing of stranded costs on an annual
16 basis, their proposal to only include the first few years of positive stranded costs in the calculation
17 can also lead to stranded cost over-recovery with no resultant sharing. Their witness admitted
18 to this shortcoming.²⁸

23 ²⁶Under A.R.S. § 40-285, a public service corporation must obtain Commission permission to dispose of
24 property that is necessary or useful in the performance of its duties to the public. *Babe Inv. v. Ariz. Corp. Comm'n*,
25 189 Ariz. 147, 151, 939 P.2d 425 (App. 1997). The purpose of § 40-285 is to prevent a utility from disposing of
resources if doing so would "loot" its facilities. *Am. Cable TV v. Ariz. Pub. Serv. Co.*, 143 Ariz. 273, 277, 693 P.2d
928, 932 (App. 1983).

26 ²⁷APS Exhibit 8 at 9 (Direct Testimony of Mr. Jack E. Davis).

27 ²⁸Mr. Higgins (Arizonans for Electric Competition), TR. at 4138-4139.

1 Other highly problematic issues are raised by the Attorney General's stock market
2 valuation methodology.²⁹ Here it is important to understand that such stock valuations would
3 have little relationship to the value of electricity resources directly. For example, interest rate
4 changes alone have a big impact on stock prices, even though nothing about electricity markets
5 may have changed. This would lead to the result that stranded costs would depend more on
6 interest rates and other non-economic aspects that determine stock prices, rather than whether
7 a power plant produces power above or below the market price of power.

8 Similarly, market valuation approaches generally require more analysis of electricity
9 markets than an administrative approach would require. This is because the Commission would
10 not only have to approve the auction process,³⁰ but would also have to evaluate the
11 reasonableness of the results by performing what would be, in essence, an administrative
12 determination of the value of the plants.

13 **2. Operational Life of Generation Assets Must Be Considered.**

14 Many parties have testified that the operational life of a generation asset is a fundamental
15 factor to properly calculate stranded cost, regardless whether an administrative valuation or
16 market valuation methodology is utilized.³¹ RUCO contends that the operational life of the asset
17 is the most important component for determining the actual amount of stranded costs.

18 Under a market valuation approach, where there is an actual sale of generation assets,
19 the Commission would need to review the sale to assure that the price received was a
20 "reasonable" market price.³² Just like a potential buyer of an asset, the Commission would be
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22 ²⁹As one of the parties noted, this approach is interesting from a theoretical perspective, but has serious
23 hurdles to be overcome. Mr. Higgins (Arizonans for Electric Competition), TR. at 4076.

24 ³⁰The auction process is a more complicated process than has been portrayed. Dr. Rose (Staff), TR. at
25 3128-3131.

26 ³¹Ms. Petrochko (Enron), TR. at 863, 865; Dr. Rose (Staff), TR. at 3082; Mr. Minson (AEPCO), TR. at 3042;
27 Mr. Bayless (TEP), TR. at 1703, 1708; Dr. Rosenberg (Arizonans for Electric Choice), TR. at 2195.

28 ³²See note 26, *supra*.

1 required to assess the operational life of the asset to determine its value. The proposed
2 alternative to an actual sale under the market valuation approach is an appraisal method, which
3 requires a similar projection of the value of the asset over its operational life.³³

4 Under the administrative valuation approach, a comparison is made of generation
5 revenues that resulted from a competitive retail market place compared to the generation
6 revenues in a regulated environment. The utility's stranded cost would be the difference of the
7 two, calculated at present value. This process would involve analyzing a utility's generation-
8 specific revenue requirements, including fixed and variable costs of generation and a proper
9 allocation of A&G expenses.³⁴ To properly allocate those expenses, it is necessary to correctly
10 unbundle a utility's generation-related expenses.³⁵

11 A proper administrative valuation of generation assets requires an assessment of the retail
12 market value of the generation assets, based on the operational life of the generating unit.³⁶
13 Under traditional regulatory treatment, as the rate base associated with the plant is recovered
14 through depreciation, the embedded cost of the plant decreases. In addition, the costs of
15 generating power appear to be decreasing.³⁷ As a result, the plant becomes more profitable in
16 the future years.

17 A fair value determination of the Affected Utilities' generation assets therefore requires that
18 the operational life of the assets be considered, regardless of the methodology the Commission
19 chooses.³⁸ For example, APS has no plans to retire any of its generation plants. This includes

21 ³³See Dr. Rosenberg (Arizonans for Electric Choice), TR. at 2214.

22 ³⁴RUCO Exhibit 1 at 23.

23 ³⁵Discussion of RUCO's unbundling proposal begins at p. 11, *infra*.

24 ³⁶For legal support of this position see *infra* p. 21-22.

25 ³⁷See Mr. Davis (APS), TR. at 3703.

26 ³⁸The Commission is required to ascertain the fair value of public service corporation property when
27 discharging its constitutional duty to prescribe rates and charges. Ariz. Const., art. 15, § 14. For further discussion,
see the "The Significance of the Calculation Period" beginning on p. 19.

1 both Navajo Generating Station and Four Corners Generating Station, two of APS' older coal
2 plants, which are approaching twenty-five years old.³⁹ Mr. Bayless testified that all of Tucson
3 Electric Power's ("TEP") generation plants have life expectancies greater than 15 or 20 years.⁴⁰
4 Clearly, failure to account for the Affected Utilities' "post-transition" ownership of generation plant
5 as a factor in assessing stranded costs would unreasonably overstate the magnitude of stranded
6 cost. Therefore, RUCO contends that it is crucial for the Commission to consider the operational
7 life of generation assets when determining stranded costs.

8 **3. Determining the Market Price**

9 **a. Unbundling**

10 The administrative valuation approach examines a utility's current embedded cost of
11 service, which requires that electric service costs be "unbundled." Unbundling refers to the
12 process dividing the utility's current single ("bundled")⁴¹ rate into separate rates for transmission
13 and distribution-related customer services, transmission, distribution, and retail generation
14 services. The purpose of unbundling is to assure that everyone pays the same basic components
15 of rates, regardless of who provides the generation service.⁴² As part of this process, A & G costs
16 and other common costs must be allocated fairly among these services. The rates for
17 transmission and distribution services and related customer services will continue to be regulated
18 by the Commission as monopoly services. Improper unbundling could result in the inclusion of
19 generation expenses in transmission and distribution rates. Such cost-shifting must be avoided,
20 so that new market entrants can compete effectively.

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22 ³⁹Mr. Davis (APS), TR. at 3825-3826.

23 ⁴⁰Mr. Bayless (TEP), TR. at 1687, 1708.

24 ⁴¹The Rules define "bundled service" as:
25 electric service provided as a package to the consumer including all generation, transmission,
26 distribution, ancillary, and other services necessary to deliver and measure useful electric energy
and power to the consumer.
AAC R-14-2-1601(2).

27 ⁴²Dr. Rosen (RUCO), TR. at 1854.

1 Unbundling must take place before stranded costs are calculated.⁴³ Following this
2 unbundling, the economic generation-related services costs would be separated from the
3 uneconomic (or stranded) generation-related service costs.⁴⁴ Once unbundled correctly, the
4 generation component of current rates is the retail price that customers are now paying for
5 generation services.⁴⁵

6 **b. Retail Market Price**

7 RUCO contends that the estimation of a retail market price should be specifically based
8 on the assumption that in a competitive retail market, the Affected Utilities will charge standard
9 offer customers a retail market price for generation services. The market price represents the
10 average energy and demand costs necessary to serve the utility's entire load. Therefore, the
11 retail market price represents the long run marginal cost of power in the region to serve a
12 particular load based on its load factor and other seasonal characteristics. This is quite different
13 from using only the marginal, non-firm, wholesale cost or spot market marginal cost at certain
14 time periods which would occur if the Dow Jones Palo Verde Index or the California Power
15 Exchange were utilized.⁴⁶ Spot wholesale energy price indices do not appropriately reflect the
16 market price of the various types and qualities of power that are likely to be sold in competitive
17 retail markets.⁴⁷ A reasonably accurate lower limit for the wholesale market clearing price should
18 rely on cost information for a new natural gas combustion turbine ("CT") and a natural gas
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21 ⁴³APS's witness agreed. Dr. Hieronymus (APS), TR. at 2644.

22 ⁴⁴RUCO Exhibit 1 at 58-59.

23 ⁴⁵Id. at 59.

24 ⁴⁶The California Power Exchange Index is representative of the marginal wholesale price of generation. Mr.
25 Davis (APS), TR. at 3678. The Dow Jones Palo Verde Index provides an on-peak and off-peak market price. Id. at
26 3638.

27 ⁴⁷Arizonans for Electric Choice Exhibit 6 at 16 (Direct Testimony of Dr. Alan E. Rosenberg); Dr. Rose
28 (Staff), TR. at 3095; Dr. Nelson (Electric Competition Coalition), TR. at 4185-4186.

1 combined cycle ("CC") plant, to determine a market price based on the optimal mix of CTs and
2 CCs to serve a particular utility's entire load profile on a firm basis.⁴⁸

3 RUCO contends that in developing estimates of the retail market price for power, it is
4 erroneous to only consider the wholesale price of power. The correct valuation is based on the
5 retail price a customer pays for generation services, which is the wholesale price plus a retail
6 margin. Other parties have agreed that in addition to the cost of buying power at wholesale, a
7 competitive generation supplier will have to incur many costs that are not embedded in the market
8 prices of bulk wholesale power.⁴⁹ These costs include A & G expenses, billing service costs,
9 customer service costs, marketing, and other transaction costs.⁵⁰ The Pennsylvania Public Utility
10 Commission has found that such expenses should be allocated to the generation function.⁵¹
11 These types of costs will be incurred by retail generation suppliers, regardless of whether they
12 provide the service from in-house resources or whether they contract with someone else to
13 provide the services.

14 It is the total price for retail generation services, as determined by the market, that will
15 determine the income that the Affected Utilities will be able to earn by participating in the retail
16 market.⁵² Using the retail price of power to compute stranded costs will result in lower stranded
17 costs and will be more likely to promote competitive entry to the market as compared to the
18 erroneous use of the wholesale price of power.

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22 ⁴⁸RUCO Exhibit 1 at 60.

23 ⁴⁹Dr. Gordon (TEP), TR. at 748-749; Ms. Petrochko (Enron), TR. at 870; Dr. Rose (Staff), TR. at 3094.

24 ⁵⁰RUCO Exhibit 1 at 60-61.

25 ⁵¹*Application of PECO Energy for Approval of its Restructuring Plan*, Docket Nos. R-00973953, P-
26 00971265, Final Opinion and Order entered December 23, 1997 at 48, 58.

27 ⁵²RUCO Exhibit 1 at 29-30.

1 **C. Stranded Costs**

2 **[Issue 3: What costs should be included as part of "stranded cost" and how**
3 **should those costs be calculated?]**

4 **1. Costs that are Stranded**

5 RUCO believes that stranded costs are comprised of some costs that are presently being
6 incurred by incumbent utilities. These include generation assets, generation-related operation
7 and maintenance costs, purchase power agreements, fuel contracts, generation-related
8 regulatory assets and liabilities, and generation-related A & G expenses. Thus, a portion of the
9 utility's power plant costs could become unrecoverable or "stranded" if market prices for retail
10 generation services were not sufficient to support full recovery of the variable production costs
11 (including fuel), fixed operation and maintenance costs, capital-addition costs, generation-related
12 A&G costs and regulatory assets/liabilities.

13 Generation-related regulatory assets include accounting reserves for deferred costs
14 related to the phase-in of new power plants, deferred income taxes, and pension funds.⁵³ Under
15 traditional regulation, a utility may also be able to collect its regulatory assets that are not yet in
16 rates. Therefore regulatory assets and liabilities, including those not yet in rates, may contribute
17 to stranded cost.

18 RUCO also contends that nuclear plant decommissioning costs and nuclear fuel disposal
19 costs are directly related to generation,⁵⁴ and should be considered part of stranded cost. Some
20 parties have proposed that nuclear decommissioning and fuel disposal costs should be recovered
21 through a mechanism that is separate from the stranded cost recovery charge. This is
22 problematic for at least three related reasons. The first is that separating these two cost
23 components from other generation costs would not reflect a correct unbundling of rates.

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25 ⁵³id. at. 61.

26 ⁵⁴Other parties have agreed that, by their very nature, nuclear plant decommissioning and nuclear fuel
27 disposal are related to generation. Mr. Davis (APS), TR. at 3832; Dr. Rose (Staff), TR. at 3127; Mr. Oglesby
28 (PG&E), TR. at 1281.

1 Secondly, having a separate recovery mechanism would prevent other negative stranded costs
2 from canceling out these positive components of stranded costs, which would result in the
3 incorrect computation of stranded costs. Thirdly, if stranded costs are shared, having a separate
4 recovery mechanism for nuclear decommissioning and fuel disposal would, presumably, preclude
5 a sharing of these costs.

6 Long-term purchase power contracts and fuel supply contracts can also contribute to
7 stranded costs, if they exceed competitive market prices for comparable goods and services and
8 were prudently incurred.⁵⁵

9 A utility's current cost to provide a retail end user with wholesale bulk power (namely
10 generation-related A & G costs) may be above or below the cost that competitive suppliers will
11 incur to provide comparable retail generation services. A utility's above-market generation
12 retailing costs would then also contribute to stranded cost. However, if the existing generation-
13 related A&G costs are below the future level of the retail margin (which is much more likely to be
14 the case), stranded costs would be reduced.⁵⁶

15 Arizona's Constitution requires that any positive stranded costs recovered by the Affected
16 Utilities through rates be just and reasonable⁵⁷ and must be based on a Commission
17 determination of the fair value of the Affected Utility property involved.⁵⁸ The Commission's fair
18 value determination must be based only on property that is "devoted to the public use."⁵⁹
19 Arizona's Supreme Court has held that in making the required fair value determination, the
20 Commission must consider all relevant factors.⁶⁰ If the Commission fails to consider all relevant

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22 ⁵⁵RUCO Exhibit 1 at 62.

23 ⁵⁶*Id.* at 62.

24 ⁵⁷Ariz. Const. art. 15, §3.

25 ⁵⁸Ariz. Const. art. 15, §14.

26 ⁵⁹*Arizona Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (1959).

27 ⁶⁰*Id.* at 201-202, 335 P.2d at 414.

1 factors, fair value has simply not been determined.⁶¹ Whether the Affected Utilities' property used
2 in calculating stranded costs is devoted to the public use or not is certainly a relevant factor which
3 the Commission will need to reasonably address when determining what costs should be included
4 in individual Affected Utility determinations of stranded costs.

5 **2. RUCO's Estimates of Stranded Cost**

6 The Affected Utilities have claimed that they have positive stranded costs. Clearly, with
7 an issue of such import, it is assumed that the Affected Utilities have analyzed their estimated
8 stranded costs. However, the actual magnitude of stranded costs for any Arizona utility is
9 unknown at this time because the Affected Utilities have failed to provide estimates. Parties have
10 requested estimates of stranded cost from the Affected Utilities since the working groups began
11 meeting. Dr. Coyle, witness for the City of Tucson, testified that the Affected Utilities should be
12 required to file their estimated stranded costs before this Commission can make a policy decision
13 on the methodology.⁶² When questioned on the record, two of the companies did provide an
14 estimate of their potential stranded costs. Jack Davis testified that the APS stranded cost figure
15 "could be in the range of \$500 million."⁶³ Sean Breen of Citizens testified that the Company's
16 stranded cost was "something less than \$100 million."⁶⁴

17 Because the companies did not file estimates of their estimated stranded cost, RUCO
18 undertook the exercise of estimating them. RUCO's consultant, Dr. Richard Rosen, calculated
19 the stranded cost for APS, TEP, and Salt River Project ("SRP"). Because each utility faces a
20 unique set of circumstances entering into the competitive generation market, Dr. Rosen utilized
21 the Tellus Strandable Costs Model, which is designed to provide an analysis of the specific
22

23
24 ⁶¹Id.

25 ⁶²Dr. Coyle (City of Tucson), TR. at 1065.

26 ⁶³Mr. Davis (APS), TR. at 3837-3838.

27 ⁶⁴Mr. Breen (Citizens), TR. at 129.

1 financial conditions for each utility.⁶⁵ Based on RUCO's estimates, it appears that the
2 *deregulation of the generation market* would not create materially significant positive strandable
3 costs for either APS or SRP, but that TEP would likely have a significant level of positive
4 strandable costs.⁶⁶

5 Dr. Rosen relied on a spreadsheet model that first performed an approximate unbundling
6 of each utility's rates based on data from each company's FERC Form 1.⁶⁷ Secondly, the
7 generation component of current rates was projected out until the year 2020. Then a wholesale
8 price for power was computed, based initially on the current cost of the wholesale power in the
9 region, which phased up to a long run marginal price for wholesale power. This long run price
10 was based on the optimal mix of CC and CT generating units to serve each utilities' load. A lower
11 limit for a retail margin was estimated for both small and large customers, and was added to the
12 wholesale price of power to compute a total retail price. This price was also projected out to
13 2020. The difference between the two price projections was multiplied by projections of annual
14 sales to compute the annual strandable costs. These annual results were then tallied to compute
15 cumulative present value of the stranded costs through 2020.⁶⁸

16 Based on his analysis, Dr. Rosen found that the potential net present value of stranded
17 costs in 1998 dollars varies substantially with different market price scenarios, and with the time
18 frames over which estimates are made. This is a typical result. More important, however, is the
19 fact that potential stranded costs for APS and SRP were consistently negative in all scenarios
20
21

22 ⁶⁵This model has been used by Dr. Rosen in a number of cases, including Texas and New York. Rosen
23 (RUCO), TR. at 1882.

24 ⁶⁶RUCO Exhibit 1 at 50-51.

25 ⁶⁷The FERC Form 1 is a mandatory filing that a regulated utility must make on an annual basis to the
26 Federal Energy Regulatory Commission, pursuant to the Federal Power Act, Sect. 3,4(a), 304, 309 and 18 C.F.R.
Sect. 141(l).

27 ⁶⁸See RUCO Exhibit 1, RAR-12, p.1-6.

1 utilized by Dr. Rosen in the time frame from 1998 to 2020; strandable costs for TEP during that
2 time period were positive.⁶⁹

3 TEP appears to be the only one of the three utilities that may have any significant level of
4 positive stranded costs. This is because ratepayers have already paid off uneconomic costs that
5 previously existed on the APS and SRP systems. This implies that unless a **negative** stranded
6 cost recovery charge is put into place for APS and SRP once retail competition begins, ratepayers
7 may pay more for electricity under retail competition over the next 15 years (and longer), than
8 they would pay if regulation were continued, and may in fact overpay their fair share of stranded
9 costs.⁷⁰

10 It is also important to note that Dr. Rosen's Basecase results indicate that after about 2003,
11 the expected average retail price of power in the unregulated market will exceed the expected
12 regulated price of generation for APS and SRP. This implies that ratepayers will likely pay more
13 under retail competition after 2003 on an **annual** basis, than if regulation were continued. This
14 forecast graphically illustrates the fact that if a negative stranded cost recovery charge is not put
15 into place for APS and SRP, or if there are no substantial operating or technological-based cost
16 reductions as a result of competition, ratepayers may not benefit from retail competition.⁷¹

21 ⁶⁹Using the Tellus Stranded Cost Model, Dr. Rosen found that under his Basecase (or most likely
22 assumptions), APS, SRP, and TEP will have strandable costs over the period 1998-2020 of **negative \$838 million**,
23 **negative \$3.0 billion**, and **positive \$513 million** in 1998 present value dollars, respectively. If the calculation
24 period is reduced to only 15 years (1998-2012), APS, SRP, and TEP will most likely have strandable costs in the
25 range of **positive \$102 million**, **negative \$834 million**, and **positive \$779 million**, respectively, in 1998 present
26 value dollars. Thus, Dr. Rosen concluded that of these three utilities, only TEP may have any significant level of
27 positive strandable costs. RUCO Exhibit 1 at 9; RAR-2 at 1; RAR-4 at 1-6; RAR-6 at 1-5; RAR-8 at 106.

28 ⁷⁰An administratively determined negative stranded cost recovery charge is equivalent to selling the
generating units of a particular utility at above net book value, and passing the profit through as a credit to the
ratepayers by reducing the existing rate base. This is the appropriate approach if a sale at above book value were
to occur under traditional regulation. RUCO Exhibit 1 at 10.

⁷¹Id. at 10.

1 opportunity to earn a competitive return on the assets, whether by selling their generation output
2 or by voluntarily divesting them.

3 For these reasons, the calculation of stranded costs must be made over the expected life
4 of the generation assets.⁷⁸ This will allow the full future economic benefits of each generation
5 resource to be credited to ratepayers, which is an equitable result since the ratepayers have
6 already paid for many years of net economic losses. Once ratepayers have paid for the
7 uneconomic costs of these power plants, it would be unfair to deny them the longer-run benefits
8 of these plants when the cost of their output is lower than market priced alternatives.⁷⁹

9 In order to arrive at a just and reasonable stranded cost recovery figure for uneconomic
10 generation assets in rate base, the Commission must use a calculation period that complies with
11 its constitutional mandate to fairly value the Affected Utilities' property devoted to the public use.⁸⁰

12 Shortly after the adoption of Arizona's Constitution, Arizona's Supreme Court held that:

13 In order that the Corporation Commission might act intelligently, justly, and
14 fairly between the public service corporations doing business in the state
15 and the general public, section 14 was written into the Constitution. . . . The
16 'fair value of the property' of public service corporations is the recognized
17 basis upon which rates and charges for services rendered should be made,
18 and it is made the duty of the Commission to ascertain such value, not for
19 legislative use, but for its own use, in arriving at just and reasonable rates
20 and charges, and to that end the public service corporations are required to
21 furnish the commission all the assistance in their power.

18 *State v. Tucson Gas, Electric Light & Power Co.*, 15 Ariz. 294, 303, 138 P. 781, 784-85 (1914).

19 When the transition to a competitive generation market is complete, the future competitive
20 returns on Affected Utilities' assets will benefit only the company and its shareholders. To
21 prevent this unequitable result, these future unregulated earnings on generation assets must be
22 reflected in stranded cost calculations. Failure to do so could unreasonably overstate the
23 magnitude of stranded cost estimates and would violate both Arizona's constitutional fair value

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25 ⁷⁸RUCO Exhibit 1 at 62-64.

26 ⁷⁹Dr. Rosenberg (Arizonans for Electric Choice), TR. at 2271.

27 ⁸⁰See Ariz. Const. art. 15, §14; *Arizona Water Co.*, 85 Ariz. at 203, 335 P.2d at 415..

1 provision and the constitutional requirement that the Commission prescribe just and reasonable
2 rates.⁸¹

3 **2. Recovery Period for Stranded Costs**

4 It is RUCO's position that the time frame for the recovery of positive stranded costs should
5 be limited to the transition period. By January 1, 2003, all Arizona consumers will have the
6 opportunity to receive competitive generation services.⁸² RUCO contends that stranded cost
7 recovery should terminate as of that date. A longer recovery period would delay the enjoyment
8 of the full potential savings brought about through a competitive generation market.⁸³

9 However, it appears from RUCO's estimates that stranded costs are significantly negative
10 for APS, and SRP. Therefore, RUCO is proposing that a credit be given to customers in their
11 distribution rate to account for any negative stranded cost that comes to light in the final true-up.⁸⁴
12 This allocation of negative stranded costs as a credit to ratepayers could extend beyond the end
13 of the transition period.⁸⁵

14 **E. Paying for Stranded Costs**

15 **[Issue 6: How and who should pay for stranded costs and who, if anyone,
16 should be excluded from paying for stranded costs?]**

17 **1. How Should Stranded Costs Be Paid?**

18 The payment of stranded cost should be made through a non-bypassable, non-
19 discriminatory "wires charge," which is also referred to as a "competition transition charge"
20 ("CTC"). The competition transition charge should be applied by the local distribution company,
21 so stranded costs would be allocated to all customers being served by the local distribution

22 ⁸¹*Id.* See also *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (Ariz.
23 1956). (the reasonableness and justness of rates must be related to fair value finding).

24 ⁸²A.A.C. R14-2-1604(D).

25 ⁸³RUCO Exhibit 1 at 70-71.

26 ⁸⁴Dr. Rosen (RUCO), TR. at 1932.

27 ⁸⁵*Id.* at 1931.

1 system.⁸⁶ Because the CTC is a distribution charge, it should not vary from supplier to supplier,
2 so purchasing power from a competitive generation source would not impact a retail customer's
3 obligation to pay for stranded cost. Therefore, competing generation suppliers would have
4 neither a competitive advantage nor disadvantage based on the recovery of the existing
5 generation owner's stranded cost.⁸⁷

6 RUCO contends that an "exit fee" should not be implemented. Exit fees are problematic
7 for several reasons. First, the lump sum payment (however it is determined) could create an
8 insurmountable financial barrier for some customers. Secondly, there is no regulatory precedent
9 for charging for stranded costs (or any other costs) when power is not purchased from the utility.
10 If a customer reduces its load, regulatory policy should not attempt to distinguish the causes of
11 the load reduction by imposing an exit fee if the reduction is due to the increased self-generation
12 of power, but not imposing that fee if the load reduction is due to energy conservation effects, or
13 shutting down an assembly line.⁸⁸ RUCO believes that recovering stranded costs from a
14 customer for load reductions due to technological change is inappropriate.

15 **2. Who Should Pay for Stranded Cost?**

16 It is RUCO's position that payment of stranded cost should be made by all customers in
17 each service territory according to its tariff class. This includes customers who now have special
18 contracts with Affected Utilities and interruptible customers. Self-generators are the only
19 exception; there is no traditional regulatory policy that would justify penalizing them.⁸⁹ However,
20 if a customer receives interruptible service, or if a customer self-generates, but chooses to remain
21 connected to the distribution system and rely on the utility for services such as back-up or
22 standby power, the customer should pay its fair share of stranded costs for the services

23
24 ⁸⁶RUCO Exhibit 1 at 77.

25 ⁸⁷*Id.* at 68-69.

26 ⁸⁸*Id.* at 81.

27 ⁸⁹RUCO Exhibit 2 at 18.

1 provided.⁹⁰ Customers on the standard offer, similar to customers under regulation today, will
2 pay for stranded costs as part of the standard offer. Under RUCO's proposal, the standard offer
3 would be unbundled, so that the same competition transition charge would be shown on standard
4 offer customers' bills⁹¹ as would be shown on the bills of customers participating in the
5 competitive generation market.⁹²

6 The charges for stranded cost recovery should be determined on a utility-by-utility basis.
7 Charges for each rate class should be determined through the traditional cost-of-service rate
8 design principles currently in effect, particularly cost causation. Through the end of the transition
9 period, tariffs for each rate class should continue to maintain the current billing determinants.
10 This approach will result in a revenue neutral unbundling. The CTC should be charged to
11 customers on the basis of cost causation, as a natural consequence of the revenue neutral
12 approach to unbundling. This methodology implies that for those customer classes having both
13 demand and energy based components of its tariff, the CTC will also have both demand and
14 energy components.⁹³

15 3. Sharing of Stranded Cost Between Ratepayers and Stockholders

16 RUCO contends that any positive stranded cost recovery should be shared between
17 ratepayers and stockholders.⁹⁴ From a policy perspective, the key factor to consider in
18 determining how to share stranded cost is equity. To burden only ratepayers with stranded costs

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20 ⁹⁰Other parties agree. See Mr. Davis (APS), TR. at 3690-3691; Mr. Minson (AEPCO), TR. at 3043.

21 ⁹¹RUCO also contends that a price cap is essential to protect customers on the standard offer from having
22 an increase in their electric service cost.

23 ⁹²One benefit to unbundling the competition transition charge on standard offer customers' bills is that it
24 would make it easier for customers to shop for services. Dr. Rose (Staff), TR. at 3123.

25 ⁹³RUCO Exhibit 1 at 81.

26 ⁹⁴RUCO is not alone in making this proposal. See Mr. Oglesby (PG&E), TR. at 1348 (the entire burden of
27 stranded costs should not be laid on ratepayers); Dr. Coyle (City of Tucson), TR. at 1052 (same); Dr. Malko
28 (Arizonans for Electric Choice), TR. at 2135; Dr. Rosenberg (Arizonans for Electric Choice), TR. at 2228 (testifying
that Vermont called for 50/50 sharing); TR. at 2241; Dr. Hieronymus (APS), TR. at 2584 (testifying that New
Hampshire provided for 50/50 sharing).

1 would be patently unfair, and could subject the Commission to charges that it behaved in an
2 unreasonable and arbitrary manner in prescribing stranded cost recovery.⁹⁵ It has been
3 suggested that placing 100% of the burden for stranded cost recovery on the ratepayers would
4 result in an unconstitutional taking from ratepayers.⁹⁶ As a starting point, a 50/50 sharing
5 between the ratepayers and the stockholders is appropriate. On a utility-by-utility basis, the
6 Commission should consider what factors led to stranded costs that might have been significantly
7 under the control of the utility, and what ratemaking treatment the assets with uneconomic costs
8 have received since their inclusion in utility rate base. Based upon those considerations, the
9 Commission can then determine whether the stockholders should be held responsible for more
10 than 50% of stranded costs.

11 Initially, the Commission should decide on the appropriate percentage of sharing for each
12 generation asset which contributes to positive stranded costs for the Affected Utility under
13 consideration. Then the Commission should weigh the results for each asset together to get an
14 overall system-wide percentage sharing. Retail ratepayers should not be responsible for more
15 than 50% of a utility's prudent stranded generation cost, unless special consideration is
16 necessary to maintain the financial integrity of the utility. Recovery should be based on a lower
17 rate of return through use of a bond rate, rather than an equity rate, which includes a risk
18 premium.⁹⁷

19 RUCO recognizes that there might be a difference between stranded costs caused by
20 generation assets (those in an Arizona utility's rate base) and the stranded costs caused by
21 uneconomic purchase power contracts. With purchase power contracts, the cost of power is
22 usually passed directly through to the customers. When costs are passed directly through, there
23

24 ⁹⁵The Commission is charged with the duty to prescribe just and reasonable rates and charges. Ariz.
25 Const., art. 15, § 3.

26 ⁹⁶Dr. Coyle (City of Tucson), TR. at 1054, 1128.

27 ⁹⁷RUCO Exhibit 1 at 69-70.

1 is no opportunity for the shareholders of the retailing utility to make a profit on those purchased
2 power costs. On the other hand, the shareholders of the utility selling the power at wholesale did
3 have an opportunity to profit. Because there was never a profit-making opportunity for the
4 shareholders of the retailing utility in this circumstance, whether the retailing utility's shareholders
5 should be required to bear any stranded costs is a determination that the Commission should
6 make on a case-by-case basis.

7 The Commission has full power to make a reasonable determination of the proportional
8 amount that ratepayers should be required to contribute toward Affected Utilities' uneconomic
9 costs. This power stems from the Commission's constitutional authority to amend public service
10 corporations' rates and charges. The Commission's constitutional mandate to prescribe just and
11 reasonable classifications, rates and charges to be made by public service corporations is
12 accompanied by a proviso "that classifications, rates, charges, rules, regulations, orders, and
13 forms or systems prescribed or made by said Corporation Commission may from time to time be
14 amended or repealed by such Commission."⁹⁸ This proviso grants the Commission all the
15 authority necessary to assure that recovery of any stranded costs is provided in a just,
16 reasonable, and equitable manner.

17 The fair value determination mandated by Arizona's constitution requires consideration of
18 all relevant factors at the time of inquiry.⁹⁹ Failure to consider all relevant factors, or an abuse
19 of discretion when considering those factors, results in a failure to comply with Arizona's fair value
20 constitutional requirement.¹⁰⁰ When the Commission makes its determination on the proportional
21 sharing of stranded costs, it must therefore consider, at a minimum, the following relevant factors:
22 1) neither the ratepayers nor the shareholders are at fault for stranded costs; and 2) with the
23 advent of competition, the Affected Utilities will not be limited to a regulated rate of return on a
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25 ⁹⁸Ariz. Const. Art. 15 § 3.

26 ⁹⁹Arizona Water Co. at 201-202, 335 P.2d at 414.

27 ¹⁰⁰Id.

1 generation plant if that plant is devoted to competitive use, other than public use. This second
2 factor is highly relevant because one of the main purposes of introducing competition is to give
3 the Affected Utilities the ability and motivation to seek higher-than-regulated returns in the
4 competitive marketplace on generation plant if it no longer devotes it to the public use.

5 **F. Price Cap/Rate Freeze**

6 **[Issue 8: Should there be price caps or a rate freeze imposed as part of a**
7 **development of a stranded cost recovery program and if so, how should it be**
8 **calculated?]**

9 RUCO recommends that the retail rates of all Affected Utilities be capped during the
10 transition period to competition, January 1, 1999 through January 1, 2003. This rate cap would
11 ensure that ratepayers would not pay more under retail competition than they would have if
12 regulated generation rates had continued throughout this period.

13 It is RUCO's position that a rate cap, which would allow for any decrease in generation
14 prices to be passed on to customers during this transition period, is the most appropriate
15 approach.¹⁰¹ In contrast, a rate freeze, which would not allow downward movement for customers'
16 rates during the transition period, is inappropriate because it would allow for utilities to receive
17 a windfall if generation costs were to decrease during this period. Additionally, a rate freeze
18 might allow for the utility to over-recover its stranded cost.

19 RUCO recommends that the rate for the standard offer generation service be capped at
20 the lower of two rates: the generation rate that would have been charged to each customer class
21 under regulation; or the market price for retail generation service plus any CTC recoverable from
22 ratepayers. Implementing a price cap during the transition period would guarantee that
23 customers would be, at a minimum, in the same position as they would have been under
24 regulation. This approach would allow all customers to enjoy the rate benefits of retail
25 competition during the transition period. Under the likely assumption that some rate decrease
26 will be possible for all utility customers, provided unbundling is done correctly, the use of market

27 ¹⁰¹See also Dr. Rose (Staff), TR. at 3078.

1 price to set the retail generation cap would also ensure that ratepayers do not pay for generation
2 costs twice: once in rates for the standard offer service and again in the stranded cost recovery
3 charge. Use of a market price to set the retail generation cap would also provide a degree of
4 customer protection in the event a utility wishes to deregulate any of its generation assets
5 currently used to serve standard offer customers.¹⁰²

6 RUCO advocates for a rate cap to protect the interests of residential consumers. If
7 implementing competition will cause the rates for Arizona's residential consumers to rise above
8 the level of regulated rates, serious questions arise as to whether opening Arizona's generation
9 industry to competition is truly in the public's best interest.

10 **G. True-up Mechanism**

11 **[Issue 7: Should there be a true-up mechanism and, if so, how would it
12 operate?]**

13 RUCO contends that it is imperative that the Commission retain authority to make
14 adjustments to stranded cost recovery estimates and mechanisms to ensure that the incumbent
15 utilities neither over- nor under-recover their stranded costs. A true-up mechanism assures
16 accuracy and equity in the collection of stranded costs, and will allow the Commission to avoid
17 the pitfall of basing stranded cost recovery charges on "surmise and conjecture."¹⁰³ It is RUCO's
18 position that a true-up is necessary to protect ratepayers under any of the proposed
19 methodologies, even market-based valuation approaches. The various administrative valuation
20 approaches require projections of future market prices and sales, as does the appraisal
21 method.¹⁰⁴ It is necessary that the Commission compare these projections to actual market
22 figures as the industry moves towards full competition. Such a comparison would satisfy the
23 requirement that Commission decisions on rates and charges be supported by substantial

24 ¹⁰²RUCO Exhibit 1 at 72.

25 ¹⁰³See *City of Tucson v. Citizens Utils. Water Co.*, 17 Ariz. App. 477, 481, 498 P.2d 441, 555 (App. 1972).

26 ¹⁰⁴The appraisal process, even if independent, contains a significant element of speculation. Arizonans for
27 Electric Choice Exhibit 2 at 27 (Direct Testimony of Dr. Alan E. Rosenberg).

1 evidence. For fair value ratemaking purposes, "[m]ere speculation and arbitrary conclusions are
2 not substantial evidence and cannot be determinative."¹⁰⁵

3 Even actual divestiture requires a true-up. As a result of competition, the book value
4 (which is the total investment in plant, net of depreciation) is not necessarily indicative of the
5 value the asset may have in the market. The Commission will need to review the sale prices for
6 these assets to ensure that the assets are not sold at "fire sale" prices, leaving the ratepayers
7 responsible for the remaining stranded costs.¹⁰⁶ These asset sale prices should also be trued-up
8 on future market prices for generation.

9 There are at least three aspects of the original derivation of the CTC that may cause the
10 stranded costs recovered to differ from those costs that are actually incurred; (1) the cost
11 assumptions used in preparing the stranded costs estimates (i.e., the market price) were
12 inaccurate; (2) the forecast of electricity sales used to set the CTC (on a per kWh basis) over the
13 transition period were inaccurate; and (3) the projection of the unbundled generation component
14 of current rates was inaccurate. In the true-up process, these aspects should be periodically
15 updated with historical information to reconcile the amount of stranded cost recovered.¹⁰⁷

16 The amount of stranded cost recovery from ratepayers should be calculated
17 administratively and trued-up annually (or at least bi-annually) to account for both actual retail
18 market prices of generation and actual changes in what the regulated costs of generation would
19 have been. The Commission should make a final review of stranded cost recovery at the end of
20 the transition period to compare the stranded cost recovered through the CTC with the stranded
21 cost actually incurred over the transition period, based on the actual market prices for retail
22
23

24 ¹⁰⁵*City of Tucson v. Citizens* at 481, 498 P.2d at 555.

25 ¹⁰⁶*See Arizona Water Co.* at 203, 335 P.2d at 415 ("the purchase price of a public utility does not
26 constitute, as a matter of law, its fair value.")

27 ¹⁰⁷RUCO Exhibit 1 at 66.

1 generation services.¹⁰⁸ If stranded costs are significantly **negative** in the final true-up, the
2 allocation of negative stranded costs as a credit to ratepayers should extend beyond the end of
3 the transition period.¹⁰⁹

4 RUCO strongly urges the Commission to establish a true-up mechanism for adjusting
5 stranded cost. A true-up of the initial stranded cost estimates would ensure that electric
6 restructuring in Arizona is carried out in the public interest and that the stranded costs actually
7 paid by ratepayers accurately reflect actual retail market prices as they become known. A true-
8 up mechanism not only protects ratepayers from paying too much in stranded cost recovery
9 charges, but also protects ratepayers from the negative price effects of an immature competitive
10 asset sales market and/or from the exercise of market power, which might cause market prices
11 to become unjustifiably and unpredictably high.

12 **H. Stranded Cost Filing**

13 **[Issue 2: When should "affected utilities" be required to make a stranded cost**
14 **filing pursuant to A.A.C. R14-2-1607?]**

15 RUCO believes that the stranded cost filings should occur as soon as possible, or at least
16 nine months before the initial implementation of retail competition. Because the phase-in to retail
17 access begins on January 1, 1999, all stranded cost filings should be made by April 1, 1998.
18 RUCO realizes that the April 1 date may be impracticable because the parties are still awaiting
19 the final order in this docket. However, RUCO believes that is necessary for all interested parties
20 to have sufficient opportunity to review and analyze a company's filing before competition begins,
21 so that an equitable level of stranded cost recovery can be established in a timely manner.
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26 ¹⁰⁸Id. at 65.

27 ¹⁰⁹Dr. Rosen (RUCO), TR. at 1931.

1 **III. OTHER ISSUES RAISED IN THIS DOCKET THAT MUST BE RESOLVED BY**
2 **COMMISSION.**

3 RUCO takes this opportunity to point out that testimony in this generic stranded cost
4 proceeding brought to light the need for the Commission to definitively address several key
5 restructuring issues in addition to stranded cost recovery so that an orderly transition to
6 competition may begin.¹¹² These issues include, but are not limited to, unbundling, consumer
7 education,¹¹³ provision for a provider of last resort,¹¹⁴ protection of low-income consumers,¹¹⁵
8 provision for consumer aggregation,¹¹⁶ and provisions to assure a competitive market structure.¹¹⁷
9 This list of important issues is not exhaustive and does not comprise a complete list of testimonial
10 references to those issues. RUCO wishes to emphasize the importance of the Commission's
11 need to timely address these and other pivotal restructuring issues in enough time to allow all
12 parties to prepare for the transition.

13 In conclusion, RUCO believes that a competitive retail electric generation market can be
14 successfully implemented. However, the introduction of competition cannot be called successful
15 if the consumers are unfairly or unjustly disadvantaged by the process. Therefore, as the
16 Commission evaluates and weighs the testimony it has received, RUCO respectfully requests that
17 it seek to balance the interests of all those who will be affected by the restructuring process in
18 order to reach a reasonable and equitable decision.

19 RUCO believes that its stranded costs recovery methodology fairly balances the interests
20 of all the parties, and that implementation of its proposal would best serve the public interest. For
21

22 ¹¹²E.g., Mr. Davis (APS), TR. at 3671-3672, 3657.

23 ¹¹³Dr. Rosenberg (Arizonans for Electric Choice), TR. at 2193-2194.

24 ¹¹⁴Mr. Fessler (TEP), TR. at 500; Dr. Rose (Staff), TR. at 3102-3103.

25 ¹¹⁵Dr. Rose (Staff), TR. at 3133.

26 ¹¹⁶Dr. Rose (Staff), TR. at 3109, 3110.

27 ¹¹⁷Dr. Gordon (TEP), TR. at 714-718; Dr. Rose (Staff), TR. at 3130-3131.

1 this reason, RUCO respectfully requests that the Commission carefully consider and adopt its
2 proposal.

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

4
5 RESIDENTIAL UTILITY CONSUMER OFFICE

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7
8 
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Attachment A - RUCO's Proposed Modifications to Retail Electric Competition Rules

R14-2-1601. Definitions

In this Article, unless the context otherwise requires:

8. "Stranded Cost" means the ~~verifiable net difference between:~~ **uneconomic portion (net sunk generation costs plus unavoidable prospective costs associated with a utility's generation that cannot be recovered in a competitive market) of a utility's costs for owning and operating its generation plants, long-term purchase power contract costs, fuel supply contract costs, generation-related regulatory assets, and regulatory assets and liabilities that are generation-related but are not recoverable under competition as defined by the verifiable net difference between:**
- a. The value of all the prudent jurisdictional assets, and obligations and costs necessary to furnish electricity (~~such as generating plants, purchased power contracts, fuel contracts, and regulatory assets~~); acquired or entered into prior to the adoption of this Article, under traditional regulation of Affected Utilities; and
 - b. The market value of those assets and obligations, ~~directly attributable to the introduction of competition under this Article.~~
9. "System Benefits" means Commission-approved utility low income, demand side management, and environmental renewables programs.

R14-2-1606. Services Required to be Made Available by Affected Utilities

B. Standard Offer Tariffs

1. By the date indicated in R14-2-1602, each Affected Utility ~~must~~ **may** file proposed tariffs to provide Standard Offer ~~Bundled Service~~ and such rates shall not become effective until approved by the Commission. **The Standard Offer rate should be set below the rates which were in effect on December 31, 1997, and below the rate cap which will be established by the Commission for the period from January 1, 1999 to January 1, 2003. The generation component of the Standard Offer Service will be a market-based level for retail generation services.** ~~If no such tariffs are filed, rates and services in existence as of the date in R14-2-1602 shall constitute the Standard offer.~~
3. Such rates shall reflect the costs of providing the service.

4. Consumers receiving Standard Offer service are eligible for potential future rate reductions authorized by the Commission, such as reductions authorized in Decision No. 59601.

R14-2-1607. Recovery of Stranded Cost of Affected Utilities

- A. The Affected Utilities shall take every feasible, cost-effective measure to mitigate or reduce offset Stranded Cost before steps are taken by the Commission to allocate recovery of stranded costs through cost reduction measures, such as improving the economic efficiency and productivity of generation plants, selling excess generating capacity, and renegotiating or buying out uneconomic power contracts, including non-utility generation contracts. ~~by means such as expanding wholesale or retail markets, or offering a wider scope of services for profit, among others.~~
- B. The Commission shall determine, on a utility-by-utility basis, the factors that led to the existence of stranded costs, the ratemaking treatment the assets with uneconomic costs have received since their inclusion in the ratebase and the appropriate percentage of sharing between ratepayers and stockholders for each generating resource which contributes to stranded costs. The Commission shall allow recovery of the appropriate portion of unmitigated costs ~~allow recovery of unmitigated Stranded Cost by Affected Utilities.~~
- H. ~~An Affected Utility shall request Commission approval of distribution charges or other means of recovering Unmitigated Stranded Cost eligible for recovery shall be recovered from customers who reduce or terminate generation service from the Affected Utility as a direct result of competition governed by this Article by taking generation service from alternative suppliers and from customers who stay with Standard Offer service, through a non-bypassable, non-discriminatory wires charge collected by the electric distribution company. , or who obtain lower rates from the Affected Utility as a direct result of the competition governed by this Article.~~
- I. The Commission shall, after hearing and consideration of analyses and recommendations presented by the Affected Utilities, staff, and intervenors, determine for each Affected Utility the magnitude of Stranded Cost, and appropriate Stranded Cost recovery mechanisms and charges. In making its determination of mechanisms and charges, the Commission shall consider at least the following factors:
 1. The impact of Stranded Cost recovery on the effectiveness of competition;

2. The impact of Stranded Cost recovery on customers of the Affected Utility who do not participate in the competitive market;
 3. The impact, if any, on the Affected Utility's ability to meet debt obligations;
 4. The impact of Stranded Cost recovery on prices paid by consumers who participate in the competitive market;
 5. The degree to which the Affected Utility has mitigated or offset Stranded Cost;
 6. The degree to which some assets have values in excess of their book values;
 7. Appropriate treatment of negative Stranded Cost;
 8. The time period over which such Stranded Cost charges may be recovered. The Commission shall limit the application of such charges to a specified time period;
 - ~~9. The ease of determining the amount of Stranded Cost;~~
 - 9.40. The applicability of Stranded Cost to interruptible customers;
 - ~~10.11.~~ The amount of electricity generated by renewable generating resources owned by the Affected Utility.
 - 11. The use of a retail price of generation as a baseline for establishing the price of Standard Offer Service.**
- J. **Stranded Cost shall may only be recovered from all customers continuing to use the distribution system based on the amount of generation purchased from any supplier. purchases made in the competitive market using the provisions of this Article.** Any reduction in electricity purchased from an Affected Utility resulting from self-generation, demand side management, or other demand reduction attributable to any cause ~~other than the retail access provisions of this Article~~ shall not be used to calculate or recover any Stranded Cost from a consumer.
- L. The Commission may order regular revisions to estimates of the magnitude of Stranded Cost.

R14-2-1608. System Benefits Charges

- A. By the date indicated in R14-2-1602, each Affected Utility shall file for Commission review non-bypassable rates or related mechanisms to recover the applicable pro-rata costs of System Benefits from all consumers located in the Affected Utility's service area who participate in the competitive market. In addition, the Affected Utility may file for a change in the System Benefits charge at any time. The amount collected annually through the System Benefits charge shall be sufficient to fund the Affected Utilities' present Commission-approved low income, demand side management, environmental, and renewables programs.
- B. Each Affected Utility shall provide adequate supporting documentation for its proposed rates for System Benefits.
- C. An Affected Utility shall recover the costs of System Benefits only upon hearing and approval by the Commission of the recovery charge and mechanism. The Commission may combine its review of System Benefits charges with its review of filings pursuant to R14-2-1606.
- D. Methods of calculating System Benefits charges shall be included in the workshops described in R14-2-1606(I).