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BEFORE THE ARIZONA CORPORATION COMMISSION
AZ CORP COMMISSION

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

DOCKET NO. U-0000-94-165
Arizona Corporation Commission
DOCKETED

MAR 16 1998

**INITIAL BRIEF REGARDING STRANDED COSTS OF
THE LAND AND WATER FUND OF THE ROCKIES, THE GRAND CANYON TRUST,
AND ARIZONANS FOR A BETTER ENVIRONMENT**

DOCKETED BY *Hmk*

The Land and Water Fund of the Rockies (LAW Fund), the Grand Canyon Trust (the Trust), and Arizonans for a Better Environment (ABE) hereby submit their initial brief in the above captioned matter. The LAW Fund is a regional non-profit environmental law center providing legal and policy assistance to community groups throughout the Rocky Mountain and Desert Southwest region, and advocating for sustainable energy policy and practices in a variety of state and national forums. The Trust is a non-profit, regional conservation organization dedicated to the conservation of the natural and cultural resources of the Colorado Plateau. The Trust began its work in 1985, currently has 5,000 members, and is headquartered in Flagstaff, Arizona. The Trust is committed to the development of clean, renewable energy sources and the efficient use of our current energy resources. ABE is a non-profit, donation-supported, educational, research, and public interest advocacy organization with a long-standing interest in energy and regulatory issues in Arizona.

Introduction and Summary

On December 26, 1996, the Arizona Corporation Commission (ACC or the Commission) issued Decision No. 59943 in this docket adopting proposed competitive electric rules as a framework for the transition to a competitive environment. In that decision, the Commission noted:

The parties were generally in agreement that competition will provide the benefit of reduced costs, at least for some consumers. However, there were

concerns raised regarding the quality of service, as well as concerns that not all customers, particularly residential customers, will receive the benefits of competition as quickly as some large industrial customers. And of course, the incumbent utilities were greatly concerned regarding the recoverability of stranded costs.

The impact of the accelerated recovery of uneconomic costs related to the production of electricity in Arizona (stranded costs) is potentially so large as to overwhelm other utility obligations and the benefits of a competitive energy market itself. We are not opposed to providing the Affected Utilities with the opportunity for recovery of legitimate, unmitigatable stranded costs. However, we are concerned that such recovery may result in price increases, effectively squeezing out funding for important public interest benefits. Thus, stranded cost calculations and recovery methods are critically important to public interest considerations and to the success of a competitive market.

The Commission needs to be very thoughtful in its decision in this proceeding. The policies established herein will be felt by the citizens of Arizona for possibly decades to come, literally a legacy of past utility and regulatory decisions and practices as a line item on monthly electricity bills throughout the state.

The Procedural Order dated December 1, 1997 established a set of nine issues to be addressed in this proceeding, with two sub-issues subsequently added by the First Amended Procedural Order, dated December 11, 1997. The LAW Fund and the Trust addressed in testimony the following four questions of the eleven identified in the procedural orders:

3. What costs should be included as part of "stranded costs" and how should those costs be calculated?
- 3a. The recommended calculation methodology and assumptions made including any determination of the market clearing price.
6. How and who should pay for "stranded costs" and who, if anyone, should be excluded from paying for stranded costs?
9. What factors should be considered for "mitigation" of stranded costs?

Specifically, a market-oriented approach involving full divestiture of Affected Utilities' competitive assets is the preferable way of determining stranded cost recoveries and addressing questions 3 and 3a. However, should an administrative method(s) be used to determine stranded costs, we urge the Commission to consider a broad range of factors which have real value - but are

often not included in some economic analyses - in determining the market value of Affected Utilities' competitive assets. Examples of such factors are reliability, environmental impact, name recognition, customer awareness, and the degree of effort required to switch suppliers. Failure to consider the value of these and other similar factors will likely result in over-recovery of stranded costs. Thus, we recommend that a new subsection (12) be added to the list of considerations included in R14-2-1607(I) which reads as follows:

12. The value and effect of non-price factors on the calculation of the market value element of the stranded cost definition.

In regard to question 6, we believe that stranded costs should be allocated, and associated recovery mechanisms designed, to reflect existing equities between customer classes as established in prior rate proceedings before the Commission. This approach to allocation and recovery is (1) fair, consistent and equitable to all customer classes, (2) a policy which maintains current customer incentives for self-generation and/or implementation of energy efficiency and conservation measures, and (3) effectively required by Section R14-2-1607(J) of the Commission's Rule.

Third, also regarding question 6, the Commission should utilize Section R14-2-1607(I)(11) to provide an incentive to Affected Utilities to fulfill their renewable resource goals. Currently, there is a bill in the Arizona state legislature that would take away the authority of the Corporation Commission to require utilities to obtain a portion of their energy sold competitively in Arizona from solar resources, no matter how small. If the Commission relies on the Affected Utilities to continue current funding levels for renewable resources through the System Benefits Charge, only minuscule amounts of renewables will be implemented over the next few years. By creating an incentive related to the recovery of stranded costs, the Commission will maintain at least one way to implement greater amounts of renewable resources up to the commitment level of Affected Utilities in the last IRP proceeding.

Finally addressing question 9, the Commission should be very thorough in its evaluation of potential mitigation and cost offset opportunities related to stranded costs. At the very least, Arizona's strong growth will provide additional revenue which will help offset stranded costs. In addition, the useful lives of existing generation assets should be carefully examined. To the extent that the lives of such assets turn out to be longer than those upon which current depreciation and amortization rates are based, annual costs can be reduced. Indeed, coal-fired power plants originally designed and built to last thirty years, are now continuing to operate for up to 50 years, and perhaps longer. As a result of such changes, stranded costs may also be reduced.

I. Stranded Costs Must be Calculated Appropriately

The Procedural Orders established two issues related to stranded cost calculation addressed by our testimony in this proceeding as follows:

What costs should be included as part of “stranded costs” and how should those costs be calculated?

The recommended calculation methodology and assumptions made including any determination of the market clearing price.

An enormous amount of time and effort was spent in the testimony and hearings in this proceeding addressing the stranded cost calculation method, (i.e. whether it should be market-based, administratively determined, or a hybrid approach), and the determination of market clearing price.

The market-based calculation methods that were proposed effectively sidestep the necessity to project a future market clearing price, as market value is determined directly. Indeed, were a roll call vote to be taken, the LAW Fund, the Trust and ABE would favor a market-based full divestiture approach. We believe that this approach would likely provide the most accurate market value and best market power result.

We recognize the ACC may not have the necessary authority to require Affected Utilities to divest all or a portion of their production assets. However, the Commission could require divestiture in order to obtain full stranded cost recovery. In other words, the Commission’s policy regarding calculation of stranded costs could be a presumption of zero, unless proven otherwise by an accurate value in a competitive environment as determined by the market through auction and divestiture. Alternatively, an administrative method may be used to estimate stranded costs for one or more Affected Utilities. If an administrative method is used, it is critical that the Commission clarify that market *value* includes factors other than price.

A. The Commission must take into account the effect of non-price factors on the market value of assets potentially strandable in a competitive market in any administrative determination of stranded costs.

To understand the context within which these issues are to be addressed we must look back to the Commission’s Restructuring Rule (December 26, 1996). The Rule sets forth a definition of stranded costs (the difference between book value and market value) with which we, and most

parties to this proceeding, agree. The careful choice of the words "market value" in section (b) of the definition cannot be over-emphasized. The clear implication is that market value is not equivalent to market clearing price, but rather is intended to be the value of the assets/obligations in question to the owner(s) in a competitive market. The Rule defines stranded costs as "the verifiable net difference between:

- a. The value of all the prudent jurisdictional assets and obligations 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 the Affected Utilities; and
- b. The market value of those assets and obligations directly attributable to the introduction of competition under this Article." [Emphasis added]

Administrative methods for determining stranded costs typically make a paper calculation of this difference. For example, the net revenues lost method determines strandable costs as the difference between revenues received by a utility in a continued regulated regime and revenues received by the utility in a competitive energy supply market. Part (a) is relatively easy to calculate as it's done routinely in rate cases. The market value (b) to customers in the competitive marketplace is somewhat more complex.

A market price can be projected before the fact, or determined after the fact, however it represents only one component of market value. To the extent that customers perceive certain other characteristics of the incumbent utility to have a positive value (e.g. reliability, customer service, etc.), then that utility can charge prices for electricity supply, and thus generate revenues, greater than the market clearing price. The greater the competitive revenue generated, the smaller the actual stranded cost. The unrefuted pre-filed direct testimony of LAW Fund witness Gilliam on this point (at page 8) is as follows:

There is a body of evidence that indicates that non-price characteristics such as reliability, environmental impact, name recognition, customer awareness, degree of effort required, and so forth affect customers' decisions regarding selection of an energy supplier. These considerations may allow an incumbent utility to charge higher prices for the energy it provides in a competitive market, thereby reducing the amount of stranded cost exposure.

The testimonies of Arizona Public Service (APS) witness Hieronymus (direct testimony, page 9), and Tucson Electric Power (TEP) witness Gordon (direct testimony, page 11) supports the notion that in a lost revenues calculation, market value relates to the revenue received in a competitive market. Further, Dr. Hieronymus defines the market value of a generating facility in the book-versus-market contribution method (direct, page 10) as the "present value of its future

earnings in a competitive environment.” Clearly, future earnings directly relate to future revenue streams.

What, then, is the proper basis for future revenue streams? Without doubt, the market clearing price, whatever it may be, serves as the floor. However, the direct testimony of TEP witness Bayless suggests a change to the stranded cost definition which, if read narrowly, could codify this very problem. His suggestion (direct, page 12) could effectively redefine market value as market price. Later in his testimony however (at page 13), he describes the net revenues lost stranded cost calculation method as using “the [revenue] amounts likely to be realized after the introduction of competition.” While this description implicitly recognizes the prices incumbent utilities may charge for electricity in a competitive market, he goes on to equate these prices with the “market’s marginal costs.” There is clearly a need for clarification of market value vis a vis market price.

The goal of competitive firms is to maximize revenue from customers, while minimizing the costs necessary to provide the service offered. To the extent that the commodity offered is homogeneous, firms compete with each other based on other factors. APS witness Dr. Landon describes this well on page 14 of his rebuttal testimony (lines 9-13):

- Q. In a competitive market, are not all firms relatively equal in terms of name recognition, marketing costs, reputation, and goodwill?
- A. No. In competitive markets, firms generally differ widely in their abilities, reputations, and performance. Competition brings out this diversity. Firms differentiate their products and service in order to attract sales from their rivals. ...

Dr. Landon goes on to agree that existing firms have reputational and other advantages. He suggests on lines 17-18 that “Unless new entrants can succeed on their merits, they do not belong in the business. Penalizing incumbents for their superiority over rival firms serves only to harm consumers.” While such arrogance might be expected from a truly superior firm in a fully competitive market, it’s difficult for us to understand the logic behind this comment coming from an incumbent monopoly utility whose uneconomic costs have been estimated in the billion dollar range. We believe these stranded cost proceedings themselves are evidence that the incumbent utilities are not seeking to “succeed on their merits.”

To be clear, these proceedings are not intended to penalize incumbents for their “superiority” over rival firms, but rather to assure that that superiority does not come at the expense of ratepayers. To the extent that incumbent utilities have competitive advantages (a point

with which APS agrees), these advantages have value. As Mr. Gilliam pointed out in his direct testimony:

One would expect that a rational customer would select the lowest cost provider, but for the values implicitly-assigned to non-price factors. If such value exceeds anticipated cost savings related to price, that customer is likely to remain a customer of the incumbent. Put another way, the customer will select the "best-value" provider of energy service. (Page 10)

Our point is simply that the Commission consider the value of these non-price factors in their stranded cost evaluations.

Interestingly, LAW Fund witness Gilliam and APS witness Landon both use AT&T as an example of customer behavior in a more competitive market. Dr. Landon indicates that millions of long-distance customers have switched from AT&T over the years to its rivals when given the opportunity to save on various products and to obtain better service. We agree. This is largely due to the very substantial savings available to customers for roughly equivalent service from AT&T competitors. The correct analogy and resulting question is: had AT&T's prices been reduced to the market clearing price for long-distance service with the difference (AKA stranded costs) charged to all customers, would millions of customers have switched providers? Probably not, as we're now seeing in the competitive electric industry in California and elsewhere.¹

Therefore, in any administrative determination of stranded costs, the Commission must take into account the effect of non-price factors on the market value of assets potentially strandable in a competitive market.

II. Stranded Costs Should be Allocated and Recovered Fairly Across Customer Classes

Issue No. 6 of the December 1, 1997 Procedural Order reads as follows:

How and who should pay for "stranded costs" and who, if anyone, should be excluded from paying for stranded costs?

¹ A front page article in the March 5, 1998 *Wall Street Journal* confirmed that price is not the only thing consumers look at when they choose an electricity supplier. Only 40% of people surveyed by Green Mountain Energy Resources say cost would be their most important consideration. "The rest put other qualities first, including service, environmental friendliness, and the ability to pay for many commodities on one bill."

A. Stranded Costs should be allocated, and associated recovery mechanisms designed, to maintain pre-existing equities between customer classes.

(1) The maintenance of current allocation and recovery methods is fair, consistent and equitable to all customer classes.

There is a long history of regulation of electric tariffs in Arizona that has resulted in a relatively fair and equitable spreading of utility costs to customer classes, and recovery of those costs from individual customer within those classes. These practices are the culmination of either negotiation or litigation processes to which all affected parties had the opportunity to participate and influence the outcome. There have been no compelling arguments advanced in this proceeding to warrant so much as a review of the delicate balancing of interests developed over many years with respect to cost allocation and recovery of generation related costs.

(2) Continuation of current ratemaking practices with respect to stranded cost calculation and recovery maintains current customer incentives for self-generation and/or implementation of energy efficiency and conservation measures.

The recovery method for stranded costs, if improperly designed, could have a detrimental effect on the incentives for customers to use energy efficiently and consider on-site distributed renewable generation. When a customer is making a decision regarding replacement of existing electric devices (lighting, appliances, heating, pumping, etc.), the higher cost of more efficient devices is offset by the cost savings related to reduced electricity consumption. Similarly, when a customer is making a decision regarding the installation of a rooftop PV panel, the cost savings related to the reduction in electricity consumption offsets the cost of the panel. Current ratemaking practices send certain price signals to customers, which can provide a bias towards or away from efficiency and self-generation.

Citizen Utilities is the only Affected Utility to propose a recovery mechanism not based on demand or energy volume. Mr. Breen carefully avoided addressing the enormous changes in price signal, and thus consumption decisions, for the customer resulting from a switch to a flat monthly charge from the current volumetric practice. For example, customer payments of stranded costs collected through a flat fee mechanism are unaffected by reductions in energy use related to increased customer efficiency or installation of distributed renewable resources (such as rooftop PV). From the customers perspective, this method reduces the incentive to invest in clean and efficient energy technologies. From a supplier perspective however, a flat charge (1) reduces the

risk associated with stranded cost recovery, and (2) reduces the likelihood that customers will invest in technologies that reduce consumption (and revenue) for the Affected Utilities.

The incentives inherent in current rate design should not be compromised.

(3) Recovery of stranded costs through a volumetric charge is effectively required by the Rule.

Section R14-2-1607(J) of the Commission's Rule indicates that the Commission specifically intended that volume reductions would not be used in recovering stranded costs:

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

Clearly, the Commission intended that the Restructuring Rule not negatively affect the customer's ability to reduce its electricity costs through self-generation, demand side management, or other means. AEPCo's suggestion, without argument or support, to delete this section of the Rule should be flatly rejected. The flat fee suggested by Citizens' is at odds with this section, and should also be rejected.

The design of the cost recovery mechanism should mirror current cost-recovery practices, i.e., any stranded costs deemed recoverable from customers in a competitive market should be allocated consistent with current practices, and the recovery mechanism designed on a volumetric basis.

B. The Commission should provide an incentive to Affected Utilities to fulfill their renewable resource goals

Section R14-2-1607(I) of the Rule addresses the factors that the Commission intends to consider in making its determinations of stranded cost mechanisms and charges. Factor number 11 reads as follows:

The amount of electricity generated by renewable generating resources owned by the affected utility.

This factor provides an important vehicle for the Commission to create an incentive as part of its stranded cost recovery policy for the Affected Utilities to achieve their renewable resource goals from the most recent IRP. The utilities have until the end of the year 2000, nearly three full

years from now, to achieve these goals. Increasing the encouragement for renewable resources is especially appropriate at this time as the Solar Portfolio Standard is being threatened by state legislative action.

We urge the Commission to provide the amounts necessary to remedy shortfalls in meeting renewable resource goals by the end of the year 2000 through an increase in the System Benefits Charge and a commensurate reduction in the stranded cost charge. The effect is to make full stranded cost recovery contingent upon the utility achieving its established renewable resource goals. This approach effectively eliminates additional rate impacts for the Affected Utility to achieve its renewable resource targets, while providing a strong incentive for the utility to meet its goals by the end of the year 2000.

TEP witness Bayless agreed under cross-examination that, in light of the legislative threat to solar resources, the LAW Fund's suggestion in this regard is one option open to the Commission for the encouragement of renewable resources. (Transcript Volume V at pages 1651-1652, February 13, 1998)

III. Mitigation and cost offsets for stranded costs

Issue No. 9 of the December 1, 1997 Procedural Order reads as follows:

What factors should be considered for "mitigation" of stranded costs?

The language regarding mitigation and offsets to stranded costs is embodied within Rule Section R14-2-1607(A). While the scope of the wording is broad enough to have generated considerable controversy in this proceeding, the clear intent is for Affected Utilities to leave "no stone unturned" in their efforts to reduce the impact of stranded costs on consumers of electricity in Arizona. In this proceeding, we offer two methods of doing so. First, the revenue enhancement benefits related to Arizona's rapid demand and energy growth should be captured. Indeed this effect is alluded to in Section A: expanding wholesale and retail markets. This growth may be both vertical (use/customer) and horizontal (number of customers). Demand and energy growth means increased revenue which should either reduce the impact of stranded cost recovery, or shorten the recovery time frame.

Second, we recommend that the useful lives of assets which will be subject to the competitive market be reviewed for possible extension, and commensurate adjustments be made to depreciation and amortization expenses. This *deceleration* of strandable asset recovery can result in a cost reduction for these assets. For example, a generating plant with a depreciable life of 30 years may have an overall cost/kWh of 5¢. A new depreciation study may determine that the useful life of this plant is now 50 years, resulting in an overall cost/kWh of 3.5¢. This may be sufficient to turn an uneconomic plant into a competitive one. Adjustments to depreciable lives of this magnitude are not uncommon to coal plants in the West.

In a similar way, the amortization period for regulatory assets should be reviewed vis a vis stranded costs. Regulatory assets represent another balance sheet item with a specified amortization period. To the extent that the Commission approves a longer amortization period, costs and required customer revenue can be reduced. This strategy doesn't actually reduce stranded costs, but rather offsets them with a separate cost reduction.

For example, we agree with APS witness Davis that, for APS, regulatory assets do not need to be addressed as stranded costs because they are already amortized and being collected through rates by 2004. However, with the start of competition there will be five years of regulatory asset amortization remaining to be collected through tariffed rates. By stretching this amortization period out to the period chosen for stranded cost recovery (anything longer than five years), an annual cost reduction will occur. This reduction can help offset the increase related to the acceleration of stranded cost recovery. Adjustment of the amortization periods for other balance sheet items should be examined as well.

Thus, the Commission should assure that the potential mitigation benefits of customer and revenue growth are captured, and the amortization periods of balance sheet items are assessed for possible extension.

IV. CONCLUSION

For the reasons explained above, the LAW Fund, the Trust, and ABE respectfully request that the Commission consider non-price factors in the market value determination in any administrative method of calculating stranded costs. Further we recommend the Commission add a new subsection (12) to R14-2-1607(I) which reads as follows:

12. The value and effect of non-price factors on the calculation of the market value element of the stranded cost definition.

Second, the Commission must maintain the pre-existing equities between customer classes when allocating stranded costs and designing recovery mechanisms. Third, the Commission should create an incentive for Affected Utilities to fulfill their renewable resource goals resulting from the last IRP. Should Arizona HB2064 be enacted into law, such an incentive may be one of the few, if not the only mechanism to promote renewable resources in Arizona. Finally, in its review of appropriate mitigation measures, the Commission should capture the revenue benefits of growth and evaluate opportunities to extend amortization periods for assets subject to a competitive market.

Respectfully submitted this 16 day of March, 1998.



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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that the original and 10 copies of the joint initial brief of the Land and Water Fund of the Rockies, the Grand Canyon Trust, and Arizonans for a Better Environment were hand-delivered to Docket Control, Arizona Corporation Commission, 1200 West Washington Street, Phoenix, Arizona 85007 this 16th day of March, 1998 and a true and correct copy was sent by United States mail, first-class, postage pre-paid, to the following persons:

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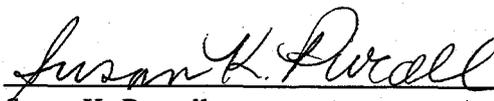
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