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BEFORE THE ARIZONA CORPORATION COMMISSION
DOCKETED

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

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

DOCKET NO. RE-00000C-94-165

STAFF'S OPENING BRIEF

Staff of the Arizona Corporation Commission ("Staff") hereby submits this brief in accordance with the March 3, 1998, Procedural Order. Staff has attempted to provide in this both a full explanation and support for the Staff position, as well as Staff's view of what should occur subsequent to this proceeding. The brief is organized to, first, explain and support the Staff position; second, provide a legal discussion of the Commission's broad discretion in treating uneconomic costs; third, a summary of the Staff position on each of the specific issues that the Hearing Officer directed be addressed in this proceeding; and, fourth, Staff's view of what should occur subsequent to this proceeding.

I. STAFF'S POSITION REGARDING UNECONOMIC COSTS.

A. Introduction.

The Staff approach to so-called "stranded costs," articulated by Dr. Kenneth Rose, is focused on transitioning to a competitive generation market with as little distortion to that market as possible. Rather than devoting inordinate attention to the details and mechanics of determining how much uneconomic costs a utility may have, Staff believes instead that the critical question is simply whether such costs may occur, and their magnitude rather than an exact number. If it is established that uneconomic costs may exist, then Staff recommends that the Commission allow recovery of "transition revenues" in an amount sufficient to meet Commission-defined criteria. Those criteria, which would be established by the Commission on a utility-specific basis, might include maintaining the financial viability of the utility, or perhaps be performance-based.

...

1 The Staff recommendation has many key benefits. First, it does not require a precise
2 calculation of the amount of uneconomic costs. Second, the Commission need not make a
3 determination that any particular portion of uneconomic costs is either recoverable or not
4 recoverable. This is because the transition revenues that would be authorized by the Commission
5 are designed not to recover uneconomic costs, but rather to meet specific criteria. Third, because
6 there is no determination regarding recoverability of uneconomic costs, adoption of the Staff
7 recommendation in this proceeding would not automatically and immediately lead to write-offs by
8 a utility. This is discussed by Staff witness Sheryl Hubbard. Finally, the Staff approach allows the
9 Commission to fashion individual criteria appropriate for each utility.

10 These benefits make the Staff approach particularly flexible and adaptive, and do not
11 mire the Commission in the complexities of attempting to determine the precise amount of stranded
12 costs. Issues of securitization are also avoided because there is no need to securitize assets in order
13 to guarantee recovery of uneconomic costs, since recovery of transition revenues is not tied to
14 recovery of uneconomic costs.

15 B. There Is No Such Thing as "Stranded Costs".

16 Staff believes that the concept of "stranded costs" is a misnomer. As pointed out by
17 Dr. Rose, in traditional economics literature, there is no such thing as "stranded costs." The concept
18 is purely a regulatory phenomenon. (Ex. S-1 at 8; Tr. at 3369-70.)

19 The Rules define "stranded costs" as the difference between the value of assets and
20 obligations necessary to furnish electricity, and the market value of those assets and obligations
21 attributable to the introduction of competition. A.A.C. R14-2-1601.8. Obviously, a purely
22 competitive market does not reflect costs under regulation. If a company in a competitive market
23 has assets whose costs exceed the market value, then those costs cannot be recovered in that market.
24 The company can write down the assets, or sell them at market value and record a loss, or remain
25 uncompetitive and eventually go out of business. In any event, the company will be unable to charge
26 above market prices in order to recover its above market costs if it wishes to remain in business very
27 long. Ultimately, the shareholders will in some manner have to absorb the uneconomic costs.
28 (Ex. S-1 at 8.)

1 The Commission here is asked to provide utilities and their shareholders with the
2 means to recover costs that are uneconomic in a competitive market. Although the moniker
3 “stranded costs” has been applied to these costs, in reality they are nothing more than uneconomic
4 costs that could be revealed to be uneconomic through the workings of a competitive market.

5 The use of a particular label for these costs may seem inconsequential. However,
6 correctly identifying these costs as “uneconomic” helps direct focus to the outcome sought to be
7 achieved through electric restructuring, which is the formation of a competitive generation market.
8 To allow recovery of uneconomic costs would be to act in a manner that is completely contradictory
9 to a competitive market: under competition, shareholders absorb uneconomic costs. It is critical for
10 the Commission to understand this phenomenon as the Commission fashions its treatment of
11 uneconomic cost issues.

12 C. Recovery of Uneconomic Costs Distorts Competitive Markets.

13 Staff believes that the development of a truly competitive generation market is the
14 intended outcome of this restructuring exercise. While this statement is hopefully obvious and not
15 a matter of any disagreement among the parties, it bears repeating because what the Commission
16 does on the issue of uneconomic cost recovery will affect the development of that market.
17 Specifically, requiring recovery of uneconomic costs from customers will have a negative impact
18 on the development of such a market.

19 The Rules explicitly require the Commission to consider “the impact of Stranded Cost
20 recovery on the effectiveness of competition” when making its determination of the mechanism and
21 charges for stranded cost recovery. A.A.C. R14-2-1607.I.1. The testimony of Dr. Rose clearly
22 establishes that such recovery will have a negative impact.

23 Dr. Rose identifies three ways in which recovery will distort a competitive outcome.
24 (Ex. S-1 at 9-10; Tr. at 3119, 3181, 3185-86, 3362-65.) First, it would act as a barrier to both entry
25 and exit from the market. Clearly, allowing an incumbent utility to recover its uneconomic costs
26 provides it with an advantage over competitors, which must absorb any uneconomic costs in the
27 marketplace. This is not an absolute barrier to entry, but certainly places competitors at a
28 disadvantage as compared to incumbents and will inhibit potential entrants. Recovery of

1 uneconomic costs also acts as a barrier to exit from the market as inefficient suppliers are not
2 deterred from continuing to operate inefficient plants. Where it would otherwise be economic to
3 exit the market in those conditions where plants are inefficient, recovery of uneconomic costs
4 changes the incentives to the supplier to exit the market.

5 Second, allowing recovery of uneconomic costs reduces the incentive to mitigate
6 those costs. This is perhaps once again a matter of stating the obvious, but if so it nevertheless bears
7 repeating. The clear mandate of the Rules, and one which the Affected Utilities certainly purport
8 to understand, is that the Affected Utilities are under an obligation to vigorously attempt to reduce
9 their uneconomic costs. A.A.C. R14-2-1607.A. A utility that is given assurance of recovery of
10 uneconomic costs will not be as tenacious about reducing costs and minimizing potential
11 uneconomic costs, nor will it be as aggressive about expanding into new market areas or retaining
12 existing customers if it believes that it will be compensated for its losses.

13 Third, recovery of uneconomic costs can distort the competitive market because an
14 asymmetry of risk and reward is created. This is because, although mechanisms are being proposed
15 for the recovery of uneconomic costs from ratepayers, there is no mechanism being proposed for the
16 refund to ratepayers of competitive gains. The Staff proposal avoids this issue by tying transition
17 revenues to particular criteria established by the Commission, not to the recovery of uneconomic
18 costs.

19 These three factors suggest that recovery of uneconomic costs can distort the
20 competitive market. The more that is recovered, the greater the impact on the market. The
21 Commission must be cognizant of this fact as it determines how to address uneconomic costs.
22 Minimization of the effect on the competitive market requires the minimization of stranded cost
23 recovery.

24 D. The Commission Should Allow Transition Revenues Only Where Necessary to
25 Achieve Commission Defined Criteria.

26 The Staff recommendation is that, rather than making a determination to allow
27 recovery of any particular portion of uneconomic costs, the Commission should instead allow
28 recovery of "transition revenues" in appropriate circumstances. The Staff believes that the

1 Commission should be most focused on transitioning to a competitive environment with as little
2 disruption as possible. As discussed above, recovery of uneconomic costs distorts that market. The
3 Commission should therefore adopt an approach that does not focus on recovery of such costs but
4 instead considers what is needed to achieve certain objectives during the transition period for
5 utilities. The transition revenue approach accomplishes this. (Ex. S-1 at 16-17.)

6 Staff recommends that transition revenues be considered for utilities that may, in fact,
7 have uneconomic costs. (Ex. S-1 at 16-17; Tr. at 3099-101, 3105-07, 3194-97.) It is not necessary
8 to calculate a precise amount of uneconomic costs, only that they exist and their estimated
9 magnitude. This is for two reasons: first, if no uneconomic costs exist for a given utility, then there
10 is no need to allow recovery of additional revenues during a transition period, because the utility will
11 already be competitive (i.e., will not have generation assets with costs greater than market value)
12 when competition arrives. Second, it is important to know the estimated magnitude of uneconomic
13 costs to ensure that the utility does not over-recover those costs.^{1/}

14 Staff recommends that the Commission establish specific criteria to be achieved by
15 the use of transition revenues. These criteria would be established individually for each Affected
16 Utility. Staff suggests that appropriate criteria could include, for example, maintaining the financial
17 viability of the utility. This might mean achieving particular coverage ratios, avoiding defaults,
18 maintaining a positive cash flow, or a variety of other means designed to maintain "financial
19 viability." The other suggested criteria offered by Dr. Rose is a performance-based measure. Under
20 this criterion, transition revenues might be designed to allow a utility to recover a percentage of the
21 difference between the utility's costs and the market price of generation, with the percentage to
22 decline each year during a transition period. A performance-based approach to transition revenues
23 obviously provides incentives to the Affected Utility to reduce costs over the transition period.

24 ...

26 ^{1/} It appears that those parties advocating a "true-up" mechanism in this proceeding are in actuality
27 advocating a "guarantee" of stranded cost recovery. Although parties give lip service to the notion that they are entitled
28 only to an "opportunity" to recover stranded costs, that "opportunity" turns to a "guarantee" where, as suggested by
AEPCO witness Dirk Minson, the true-up mechanism would help to ensure that no more *and no less* than the authorized
amount of uneconomic costs are recovered. (Ex. AEPCO-3 at 5.)

1 Staff does not believe it necessary for the Commission to adopt in this proceeding the
2 specific criteria to be met by transition revenue recovery. The proper criteria might be different
3 under different circumstances. Establishment of the particular criteria should be done in
4 utility-specific proceedings designed to estimate the direction (i.e., positive or negative) and
5 magnitude of uneconomic cost. It is only after the criteria are established for the utility that the
6 amount of transition revenues, if any, is calculated.^{2/} Conceivably, even where an Affected Utility
7 has an estimated positive amount of uneconomic costs, transition revenues may be unnecessary to
8 meet the criteria. Likewise, recovery of the full estimated amount of uneconomic costs may be
9 necessary. The critical point to remember is that transition revenues are designed not to recover
10 uneconomic costs, but to achieve other objectives during a transition to the competitive market.
11 Those objectives and necessary criteria are best determined on a case-by-case basis for each Affected
12 Utility.

13 E. A Transition Revenue Approach Provides Proper Incentives to Reduce Uneconomic
14 Costs.

15 As discussed above, allowing recovery of uneconomic costs distorts the transition to
16 a competitive market by reducing the incentive to mitigate those costs. (See e.g., Tr. at 3364-65.)
17 The Staff's transition revenues approach, by not guaranteeing recovery of all unmitigated costs,
18 provides a much stronger incentive to mitigate those costs. (Ex. S-1 at 23; see also Ex. LWF-1 at
19 15.)

20 F. a Transition Revenue Approach Does Not Automatically Lead to a Write-off of
21 Assets.

22 Certainly one of the concerns for the Affected Utilities is what effect the
23 Commission's treatment of uneconomic costs will have on the balance sheet. In particular, will a
24 Commission decision in this proceeding lead to write-offs. The testimony of Staff witness Sheryl
25 Hubbard makes clear that adoption of the Staff's recommended transition revenues approach in this
26 proceeding will not automatically lead to immediate write-offs. (Ex. S-3 at 6.)

27
28 ^{2/} Staff believes that, in appropriate circumstances, transition revenues should be set a level to allow full
recovery of regulatory assets. (Tr. at 3085-86, 3141-42.)

1 The reason is simple. The transition revenues approach does not require the
2 Commission to make any determination about recoverability of uneconomic costs. The Commission
3 does not conclude that such costs are recoverable, or not recoverable, or what percentage of such
4 costs are recoverable. (Ex. S-2 at 3; Tr. at 3133-34, 3188.) a decision by the Commission in this
5 proceeding that an Affected Utility is entitled to recover only a portion of its uneconomic costs may,
6 indeed, trigger write-offs. However, under the Staff's transition revenues approach, the Commission
7 does not decide the recoverability of uneconomic costs. Instead, the Commission would determine,
8 in this proceeding, that it will later establish specific criteria for each utility which will then be
9 utilized to determine an amount of transition revenues to be allowed (in the event it is determined
10 that the utility does, in fact, have uneconomic costs).

11 In order to determine the accounting implications of the Commission's actions (i.e.,
12 whether write-offs will be triggered), it is necessary to analyze all regulated cash inflows and
13 compare that to costs to be recovered, or cash outflows. To the extent that the inflows exceed the
14 outflows, no write-offs or write-downs will be required. This analysis cannot be performed until the
15 amount of transition revenues is determined by the Commission, which will occur in a subsequent
16 proceeding. Until that time, it is possible only to speculate on the accounting implications because
17 the total regulated cash inflows is yet to be determined.

18 Consequently, there should be no fear that adoption of the transition revenues
19 approach in this proceeding will lead to write-offs or write-downs of assets at this time.

20 G. Calculation of Uneconomic Costs Need Not Be Precise.

21 One of the significant benefits of the transition revenues approach is that there is no
22 need for the Commission to make a precise calculation of uneconomic costs, because recovery of
23 transition revenues is not tied to any amount of uneconomic costs. Allowance of transition revenues
24 is dependent on an Affected Utility in fact having uneconomic costs. But knowing the precise
25 amount is not necessary since the transition revenues are not intended to recover any particular
26 portion of those costs. Instead, transition revenues are designed to meet criteria established by the
27 Commission.

28 ...

1 Although it is unnecessary to calculate the precise amount of uneconomic costs, it
2 is necessary to know both whether such costs exist, and an estimate of the magnitude of such costs.
3 Obviously, if no uneconomic costs exist, then there is no need for revenues to assist an Affected
4 Utility in the transition to a competitive market. Calculation of those costs is therefore not a futile
5 or useless exercise. Knowing at least an estimated level of uneconomic costs is also necessary in
6 order to ensure that an Affected Utility is not allowed to recover through transition revenues more
7 than those costs.

8 In addition to avoiding the need to calculate a precise amount of uneconomic costs,
9 the transition revenues approach also can obviate the need for engaging in a true-up exercise. a
10 true-up, as envisioned by many of the parties to this proceeding, is nothing short of a means to
11 guarantee that the full amount of uneconomic costs authorized for recovery is, in fact, recovered.
12 (Tr. at 3076, 3323.) While acknowledging that the Affected Utilities are entitled only to an
13 "opportunity" to recover their uneconomic costs, many parties believe that a true-up is necessary to
14 ensure that those costs are, actually, recovered.

15 This type of true-up approach is appropriate for situations such as adjustor
16 mechanisms, where the Commission has authorized a utility to calculate specifically identifiable
17 costs for later dollar-for-dollar recovery. The Commission assures recovery of those expenses, thus
18 relieving both ratepayers and shareholders with risks associated with costs that are a significant part
19 of the cost structure of the utility and which may fluctuate greatly between rate cases. a true-up
20 mechanism is appropriate in those circumstances, and others, to ensure that a specific dollar amount
21 authorized by the Commission for recovery is in fact recovered, no more and no less.

22 Other than those types of situations, such as adjustor mechanisms, where recovery
23 of a particular dollar amount is in effect guaranteed by the Commission, a utility has no expectation
24 other than it will have an opportunity to recover its costs. When investments in generation assets
25 were made in the past, they were made with no expectation of guaranteed cost recovery, or of a
26 guaranteed return. Rather, the expectation was that there would be an opportunity to recover those
27
28

1 costs.^{3/} Those parties advocating true-up mechanisms for uneconomic cost recovery are in effect
2 elevating recovery of those costs from an opportunity to a guarantee. (Tr. at 3076, 3323.) In other
3 words, the approach taken by those parties would exceed the expectations of shareholders when the
4 investment was made. This is inappropriate.

5 The Staff's transition revenue approach reduces the need for a "true-up" mechanism.
6 a "true-up" is not needed to ensure that all uneconomic costs are recovered. To the contrary, a
7 "true-up" is needed under the Staff approach, if at all, only to ensure that there is no over-recovery
8 of uneconomic costs. If the transition revenues authorized by the Commission would recover only
9 a small portion of the uneconomic costs, then there would be very little need for any such true-up.
10 (Ex. S-1 at 22-23; Tr. at 3101.)

11 H. Top Down Approach Is Preferable for Estimating Amount and Direction of
12 Uneconomic Costs.

13 Because determining the precise amount of uneconomic costs is not critical to Staff's
14 transition revenues approach, selecting the methodology to be used to calculate those costs is
15 likewise not as critical as it might otherwise be. The major competing approaches to this calculation
16 are the asset-by-asset bottom up approach, or the net revenues lost top down approach.^{4/} Staff
17 prefers the top down approach not because it is necessarily more accurate, but because it requires
18 fewer data points to calculate.

19 Calculating uneconomic costs with either method will produce a range of results,
20 dependent upon assumptions. It is likely that the ranges produced by those methodologies will
21 overlap to some degree. It is this overlap that provides confidence that the methodologies are
22 unlikely to produce wildly divergent results. (Ex. S-2 at 1; Tr. at 3080, 3104-05.)

24
25 ^{3/} At some point, investors became aware of the potential of competition, and investments were made
subject to that knowledge. Investors have been aware of the advent of competition for several years. (Tr. at 3160-65.)

26 ^{4/} Both the Attorney General and the Goldwater Institute recommend a stock market approach to valuing
27 uneconomic costs. The fatal drawback to their approach is that the stock market and stock prices fluctuate daily and
include investors' speculation on the future prospects of the Company. Determining what day to look at the stock price
28 to value uneconomic costs would be as arbitrary as determining what percentage of uneconomic costs ought to be
recovered. (See Tr. at 3205.)

1 The bottom up approach would require that a market value be established for each
2 generation asset. If an auction or divestiture process were to be used, the time necessary to set up
3 the appropriate procedures could very well extend into 1999. This presents an unnecessarily lengthy
4 process. Furthermore, as described by Dr. Rose in detail in his Rebuttal Testimony, pp. 4-9, there
5 is a very real possibility that, even if divestiture helps to mitigate the uneconomic costs by selling
6 assets at greater than book value, the purchasers will nevertheless need to recover their costs of the
7 assets through the rates they charge to customers. (Tr. at 3141-44.) Thus, while the utility's
8 uneconomic costs may be reduced, those costs would simply have to be recovered by the new
9 owners.

10 Finally, use of an asset sale or voluntary divestiture to calculate uneconomic costs
11 has raised the twin issues of whether divestiture is "voluntary" if it is required to be able to recover
12 uneconomic costs, and whether the Commission has the authority to require divestiture. The Staff
13 by no means concedes that the Commission lacks such authority. To the contrary, the Commission's
14 broad constitutional ratemaking and classification authority provide the Commission the necessary
15 ability to require divestiture. Nevertheless, this is a dispute that can easily be avoided by adoption
16 of the top down methodology.

17 The top down methodology, as explained in detail in Dr. Rose's testimony, requires
18 a comparison between the revenues generated for a utility in a competitive generation market and
19 those generated in the current regulated market. (Ex. S-1 at 18-20; see Tr. at 3081-83.) Although
20 this calculation requires analysis and making a number of assumptions about the future, it is a
21 calculation well suited to the administrative process, and can be accomplished in a reasonable time
22 frame. Furthermore, as stated earlier, there are fewer data points required for this analysis than for
23 the bottom up approach, because the top down analysis looks at company revenues as a whole, rather
24 than attempting to make a determination of value for each generation asset owned by a utility.

25 Staff is not stating that the top down methodology is perfect, nor that the bottom up
26 approach is fatally flawed. However, Staff believes that the top down approach is the preferable
27 method to be utilized in conjunction with the transition revenues approach.

28 ...

1 **II. THE COMMISSION HAS A BROAD RANGE OF DISCRETION IN DETERMINING**
2 **THE TREATMENT OF ALLEGED STRANDED COSTS.**

3 As discussed above, Staff has recommended that the focus of the Commission's
4 review of any uneconomic cost issues revealed by the transition to a competitive market should be
5 centered on transition revenues that are intended to meet specific criteria. If there are any
6 uneconomic costs, Staff, as well as other parties, has recommended that the utilities be placed at risk
7 for mitigation of any stranded costs. In contrast, the utilities generally claim that they are entitled
8 to recover all stranded costs from their customers. It is clear from these proceedings that competition
9 in the generation market is in the public interest. Apparently the Affected Utilities contend that,
10 notwithstanding that public interest, unless and until their ratepayers are held to guarantee recovery
11 of all the utilities' stranded costs due to uneconomic losses, the transition to competition should not
12 be allowed to occur. This guarantee of stranded cost recovery is alleged to be found in a regulatory
13 compact and in constitutional and statutory mandates. The utilities' claims are not compelling. The
14 Commission has a broad range of ratemaking discretion under which it can determine how the
15 transition to a competitive generation market is best accomplished, including the determination of
16 whether it is in the public interest to have ratepayers guarantee recovery of the utilities' alleged
17 stranded costs.

18 A. Reconsideration of Legal Matters Already Determined by the Courts Is Not
19 Appropriate in the Proceeding.

20 The testimony of several parties addresses the existence of a regulatory compact or
21 contract between the utilities and the State of Arizona or the Commission. See, e.g., Fessler,
22 Bayless. They rely on the existence and terms of such a "contract" as a basis for arguing that
23 recovery of stranded costs is required. Their reliance and arguments are misplaced.

24 As pointed out by Staff witness Dr. Kenneth Rose, "the term regulatory compact is
25 a metaphor that refers to the nature of regulation of a regulated monopoly." (Ex. S-1 at 2.) A
26 regulatory compact does not create a contract with the State of Arizona or the Commission, nor has
27 it ever provided utilities with an "ability" to recover costs and earn a return. Rather, utilities have
28 been afforded an "opportunity" to recover those costs and earn return. Never has there been a

1 guarantee of recovery. Furthermore, the Commission has the ability to modify its policies and
2 decisions. Ariz. Const., art. XV, § 3; A.R.S. § 40-252.

3 This is consistent with the Commission's analysis contained in Decision No. 59943,
4 adopting the Retail Electric Competition Rules, where the Commission stated:

5 We are not convinced that the regulatory policy of the state has
6 formed any sort of contract with the Affected Utilities. It appears that
7 the former "policy" of regulated monopoly was just that - a policy,
8 made with no intent to bind the state or the Commission. Finally, we
9 recognized, as should the utilities, that such regulatory policies are
10 always subject to change as the economics and technologies of the
11 time also change.

12 Decision No. 59943, pp. 36-37, Dec. 26, 1996 (emphasis added).

13 Two different judges have upheld the Commission's Electric Competition Rules
14 against arguments that the Commission "cannot unilaterally modify or abrogate the so-called
15 regulatory contract" Nov. 19, 1997, Minute Entry and Order, p. 2, Tucson Electric Power Co.
16 v. The Arizona Corporation Commission, et al., No. CV 97-03748 (Consolidated), Maricopa County
17 Superior Court; see, Jan. 16, 1998, Minute Entry and Order, pp. 9-10, Arizona Electric Power
18 Cooperative, Inc., v. The Arizona Corporation Commission, No. CV 97-03920 (Consolidated),
19 Maricopa County Superior Court. (Copies are attached.)

20 Consequently, reliance by such witnesses as Fessler (Ex. TEP-1 at 25-27) and (Ex.
21 TEP-11 at 3-4) on the existence or terms of a regulatory compact for the proposition that utilities are
22 guaranteed recovery of "stranded costs" is not only misplaced, it is also a collateral attack on
23 Decision No. 59943. That decision has already been appealed and is being litigated. The
24 Commission's authority to adopt the rules, to move to a competitive environment, and to modify its
25 policies has been approved by the Courts.^{5/} Arguments by parties in this proceeding that the
26 Commission is legally bound by a regulatory compact or contract to provide stranded cost recovery
27 should be completely disregarded. Nonetheless, in the event the Commission may find a
28 discussion of the relevant law helpful in this proceeding, Staff provides the following legal analysis

^{5/} The Commission notes that AEPCO and certain cooperatives filed a Special Action in the Arizona
Supreme Court on March 6, 1998 seeking to overturn Judge Dann's Minute Entry in favor of the Commission. a
procedural schedule has been set for responsive pleadings and the Court will initially consider the Special Action
without oral argument on April 21, 1998.

1 on the implications of any alleged regulatory compact upon stranded cost recovery. In addition,
2 Staff's legal analysis addresses stranded cost recovery claims in the context of the Commission's
3 constitutional authority.

4 B. There Is No Regulatory Contract or Compact That Guarantees the Utilities
5 Recovery of Stranded Costs.

6 The apparent premise for the regulatory contract argument as the basis for stranded
7 cost recovery is that because the utilities provide electric service to their customers, the state (or
8 Commission) has somehow contracted with the utilities to guarantee in perpetuity the utilities'
9 recovery of 100% of their alleged uneconomic costs in providing that electric service from their
10 customers. However, there is no actual regulatory contract or compact between the state (or
11 Commission) and the utilities that guarantees recovery of the utilities' uneconomic costs which has
12 been established. There is no special language found within the early statehood 1912 statutes or the
13 Arizona Constitution that demonstrates the state's intent to enter a contract. One may search the
14 1912 Public Service Corporation Act in vain to find any mention of the term "contract" or
15 "compact". Likewise, any argument that the utilities' claim for guaranteed stranded cost recovery
16 is part of an alleged monopoly contract right must also fail. The 1912 Public Service Act does not
17 refer to "monopoly" or "exclusivity." See Laws 1912, Ch. 90. Moreover, the Arizona Constitution
18 expressly disfavors monopolies: "[m]onopolies and trusts shall never be allowed in this State"
19 Ariz. Const. art. XIV, § 15.

20 Any reliance on A.R.S. § 40-281 to establish a contract is also misplaced. The text
21 of Section 40-281 does not provide monopolistic pricing for public service corporations:

22 If a public service corporation, in constructing or extending its line,
23 plant or system, interferes or is about to interfere with the operation
24 of the line, plant or system of any other public service corporation
25 already constructed, the commission... may, after hearing, make an
order and prescribe terms and conditions for the location of lines,
plants or systems affected as it deems just and reasonable.

26 A.R.S. § 40-281.B (emphasis added). The Commission is given the discretion to determine terms
27 and conditions for the reasonable *location* of lines and systems. Section 40-281 prevents the
28 unnecessary or unreasonable duplication of lines within a given area, and it allows the Commission

1 to determine the just and reasonable location of lines. Specifications regarding the location of lines
2 are not equivalent to a guarantee of a monopoly in perpetuity, much less as the basis for recovery
3 of uneconomic costs.

4 Absent an explicit expression of the state's intent to bind itself, courts will not
5 construe a regulatory statute as a contract to which the state is a party. The party asserting the
6 creation of a contract by statute must overcome a presumption against its formation, and courts will
7 be cautious both in identifying a contract within the language of a regulatory statute and in defining
8 the outlines of any contractual obligation. Nat'l R.R. Passenger Corp. v. Atchison, Topeka, and
9 Santa Fe Ry. Co., 470 U.S. 451, 466 (1985); Hoffman v. City of Warwick, 909 F.2d 608, 614 (1st
10 Cir. 1990); McGrath v. Rhode Island Retirement Bd., 906 F. Supp. 749, 759 (D.R.I. 1995).
11 "[A]bsent some clear indication that the legislature intends to bind itself contractually, the
12 presumption is that 'a law is not intended to create private contractual or vested rights but merely
13 declares a policy to be pursued until the legislature shall ordain otherwise.'" Nat'l R.R. Corp., 470
14 U.S. at 465-66 (quoting Dodge v. Bd. Educ. of City of Chicago, 302 U.S. 74, 79 (1937)).

15 Although Arizona courts have used "regulatory compact" as a metaphor to describe
16 the nature of regulated monopoly, *see, e.g., Application of Trico Electric Cooperative, Inc. v. Senner*,
17 92 Ariz. 373, 380-81, 377 P.2d 309, 315 (1962), such references do not by themselves create a
18 binding contractual obligation for purposes of Arizona law. The State of Arizona cannot be
19 contractually bound by abstract theories or metaphors. Any valid, enforceable contract to which the
20 state is a party must exhibit the same elements of contract formation that apply to other contracts.^{6/}

21 Further, a promise of monopoly pricing in perpetuity should not be inferred from
22 silence. *See Merrion v. Jicarilla Apache Tribe*, 455 U.S. 130, 148 (1982) (waiver of tribe's taxing
23 power would not be implied from silence); United States v. Cherokee Nation of Oklahoma, 480 U.S.
24 700, 707 (1987) (refusing to infer conveyance of government's navigational easement for river bed
25 from silence). "[a] contract with a sovereign government will not be read to include an unstated

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28 ^{6/} In Arizona, a contract is formed through an offer, an acceptance, consideration, and sufficient
specification of terms. K-Line Builders, Inc. v. First Federal Sav. & Loan Ass'n, 139 Ariz. 209, 212, 677 P.2d 1317,
1320 (App. 1983).

1 term exempting the other contracting party from the application of a subsequent sovereign act..., nor
2 will an ambiguous term of a ...contract be construed as a conveyance or surrender of sovereign
3 power.” United States v. Winstar Corp., 518 U.S. 839, (1996). a promise of a perpetual monopoly
4 is equivalent to a promise not to change the law. In this case, the state has not expressly or impliedly
5 waived its sovereign power to change the law, i.e., to change the form that regulation may take.
6 Therefore, the utilities’ claim that they are somehow guaranteed recovery of uneconomic costs
7 because the form of regulation has changed is equally misplaced.

8 C. No Alleged Regulatory Contract or Compact Prohibits the
9 Commission from Acting under its Constitutional Ratemaking
10 Authority to Modify the Framework for Rate Setting from Monopoly
11 to Competitive Market for Generation.

12 Even assuming there is a regulatory contract, the Commission’s exercise of its
13 constitutional powers is not a breach or impairment of the alleged contract. The Commission has
14 determined under its constitutional ratemaking authority that customer choice in the generation
15 market will result in just and reasonable rates for electric service. The utilities’ claim that if
16 customer choice is permitted, they will incur stranded costs as a result. The utilities’ likely argument
17 is that these stranded costs must be recovered from the ratepayers because they have been
18 contractually made responsible under an alleged regulatory compact; it may further be alleged that
19 the failure to hold the customers responsible for 100% stranded costs breaches or impairs this
20 contract. However, the utilities have not pointed to any writing that expressly binds the state to
21 monopolistic pricing, rather than competitive pricing. Moreover, they have not pointed to any
22 writing that makes ratepayers guarantors of their costs.

23 Arizona court decisions have referred to regulated monopoly as a public policy, rather
24 than as a contractual obligation. See Ariz. Corp. Comm’n v. Super. Ct., 105 Ariz. 56, 59, 459 P.2d
25 489, 492 (1969)(regulated monopoly held to be public policy of Arizona); Winslow Gas Co. v.
26 Southern Union Gas Co., 76 Ariz. 383, 385, 265 P.2d 442, 443 (1954) (referring to Arizona’s public
27 policy of controlled monopoly); Pacific Greyhound Lines v. Sun Valley Bus Lines, Inc., 70 Ariz.
28 65, 71, 216 P.2d 404, 408 (1950)(same); Corp. Comm’n v. Pacific Greyhound Lines, 54 Ariz. 159,
177, 94 P.2d 443, 450 (1939)(same). Even though the Commission has permitted the utilities to

1 operate as a monopoly, the source of the authorization was regulatory, not contractual. The
2 Commission has the constitutional and statutory power to determine the services that a utility will
3 provide and how they shall be provided.^{7/}

4 The argument has also been made that because the utilities are required to serve
5 customers, the customers owe the utilities recovery of uneconomic costs. The obligation to serve
6 is a requirement of state law, not a contract term. CC&Ns are an extension of the Commission's
7 powers, not the genesis of it. Williams v. Pipe Trades, 100 Ariz 14, 17, 409 P.2d 720, 722 (1966).
8 The Commission's power over classifications and rates is "exclusive and plenary.... It is not
9 dependent upon the public service corporation being subject to a [CC&N]." Tonto Creek Estates
10 Homeowners Ass'n v. Ariz. Corp. Comm'n, 177 Ariz. 49, 58, 864 P.2d 1081, 1090 (emphasis
11 supplied). The Commission is the only branch of Arizona government that can exercise rate making
12 authority. The Commission has exclusive power to determine how an electric utility will recover
13 its costs, how its rates will be set, and how its services will be classified. Scates v. Ariz. Corp.
14 Comm'n, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App. 1978); Simms v. Round Valley Light
15 and Power Co., 80 Ariz. 145, 154, 294 P.2d 378, 384 (1956). This authority includes the
16 determination of recovery of stranded costs, not as a matter of contract, but as an exercise of
17 ratemaking by the Commission.

18 The fair value provisions of Article XV, Section 14 of the State Constitution allow
19 the Commission to use the fair value of the property of a public service corporation to assist the
20

21 ^{7/} See, e.g., Ariz. Const. art. XV, § 3 (The Commission has "full power to ... make reasonable rules,
22 regulations, and orders, by which ... [utilities] shall be governed in the transaction of business within the State, and may
23 ... make and enforce reasonable rules, regulations, and orders for the convenience, comfort, and safety, and the
24 preservation of the health, of the employees and patrons of such corporations ..."); A.R.S. §§ 40-321.a ("When the
25 commission finds that the equipment, appliances, facilities or service of any public service corporation ... are unjust,
26 unreasonable, unsafe, improper, inadequate, or insufficient, the commission shall determine what is just, reasonable,
27 safe, proper, adequate or sufficient, and shall enforce its determination by order ..."); -321.B ("The commission shall
28 prescribe regulations for the performance of any service or the furnishing of any commodity and upon proper demand
and tender of rates, the public service corporation shall ... render the service ... upon the conditions prescribed."); -
322.A.1 (The Commission may "[a]scertain and set just and reasonable standards, classifications, regulations, practices,
measurements or service to be furnished and followed by public service corporations ..."); -322.A.2 (The Commission
may "[a]scertain and fix adequate and serviceable standards for the measurement of quantity, quality, ... or other
condition pertaining to the supply of the ... service furnished by such public service corporation."); -361 ("Every public
service corporation shall furnish and maintain such service, equipment and facilities as will promote the safety, health,
comfort and convenience of its patrons, employees and the public, and as will be in all respects adequate, efficient and
reasonable.")(emphasis added throughout).

1 Commission in determining rates. See Ariz. Const. art. XV, § 14. In a monopoly setting, fair value
2 artificially determines rates as if the rates were set in a competitive market. See Duquesne Light Co.
3 v. Barasch, 488 U.S. 299, 308 (1989) (fair value rate setting is designed to mimic the competitive
4 market). If the rates are based upon a competitive market, then the Commission's fair value
5 determination has been accomplished in a much more accurate and efficient manner than in a
6 monopolistic setting. Merely because uneconomic costs are revealed as a consequence of the
7 transition to a competitive market does not breach or impair any alleged contract.

8
9 D. The Utilities Do Not Have Constitutional Rights to Continued Monopoly or
10 to Be Shielded from All Economic Consequences of Competition in the
11 Generation Market.

12 Nothing under the Arizona Constitution, statutes or cases demonstrates that any
13 particular method of regulation is intended to be carried out in perpetuity. If uneconomic costs are
14 revealed through the transition to a competitive generation market, no constitutional provision
15 mandates that these losses be recovered through stranded costs guaranteed by ratepayers. Los
16 Angeles Gas and Electric Corp. v. Railroad Comm'n of Cal., 289 U.S. 287, 306 (1933). (Public has
17 not underwritten the utilities' investment). Under traditional rate of return regulation, utilities are
18 provided no more than an opportunity to earn a fair return. Federal Power Commission v. Hope
19 Natural Gas, 320 U.S. 591, 605 (1944); Bluefield Water Works & Improvement Co. v. Public
20 Service Commission, 262 U.S. 679, 692 (1923). There is no compelling reason to turn that
21 opportunity into a guarantee.

22 Nor does the Arizona constitutional provision related to fair value preclude
23 competition or guarantee stranded cost recovery from ratepayers. The fair value provision of the state
24 constitution does not limit the Commission to traditional rate of return regulation. Neither the
25 Constitution nor case law mandates that the Commission (1) follow a particular method in its rate
26 making determinations or (2) exclude other relevant factors when it exercises its Section 3 powers.
27 Simms, 80 Ariz. at 151, 294 P.2d at 382. When the Commission determines fair value, courts
28 recognize that no one method serves as a precise measure. Id. at 154, 292 P.2d at 384. In
determining fair value, the Commission, by necessity, has a "range of legislative discretion." Id.

1 Reasonable judgment concerning all relevant factors is required.^{8/} Ariz. Corp. Comm'n v. Ariz.
2 Water Co., 85 Ariz. 198, 201, 335 P.2d 412, 414 (1959).

3 The Constitution and case law do not prohibit the Commission from considering
4 market conditions as a relevant factor in setting just and reasonable rates. See Elizabethtown Gas
5 Co. v. Fed. Energy Regulatory Comm'n, 10 F.3d 866, 870 (D.C. Cir. 1993) (market rate for
6 competitive service was just and reasonable under FERC's continuing oversight); Tejas Power Corp.
7 v. Fed. Energy Regulatory Comm'n, 908 F.2d 998, 1004 (D.C. Cir. 1990) (rational to assume that
8 market rates for competitive services are reasonable). The injection of competitive pricing into
9 regulated markets is not inconsistent with fair value rate making, since fair value is meant to mimic
10 competitive markets. See Duquesne, 488 U.S. at 308.

11 Similarly, the Constitution and case law do not prohibit the Commission from
12 considering market conditions as relevant factors to determine stranded cost recovery. If the market
13 rate for competitive services is just and reasonable, to have ratepayers act as guarantors for recovery
14 of uneconomic costs associated with these competitive services may well result in unjust and
15 unreasonable stranded cost recovery rates. Just and reasonable rates do not shield utilities from
16 uneconomic losses or guarantee revenues. Conversely, competition does not justify unjust rates.
17 See PSC of Mont. v. Great Northern Utilities Co., 289 U.S. 130, 135 (1932).

18 E. Determining That the Utilities Should Be at Risk Through Mitigation
19 for Uneconomic Costs Does Not Confiscate the Utilities' Property.

20 The Affected Utilities have no property right in continued monopoly in any particular
21 regulatory framework, or in a guaranteed return. "Whether competition between utilities shall be
22 prohibited, regulated or forbidden is a matter of state policy. . . .The declaration of a specific policy
23 creates no vested right to its maintenance in utilities then engaged in the business or thereafter
24 embarking in it." Tennessee Electric Power Co. v. Tennessee Valley Authority, 306 U.S. 118, 141
25 (1939). Since Tennessee Valley Authority, courts have affirmed that private enterprises do not have

26
27 ^{8/} The United States Constitution does not bind rate making bodies to the service of any single formula
28 or combination of formulas. Duquesne, 488 U.S. at 313-14. "If the Commission's order, as applied to the facts before
it and viewed in its entirety, produces no arbitrary result, our inquiry is at an end." F.P.C. v. Natural Gas Pipeline
Company, 315 U.S. 575, 586 (1942).

1 a right to be free from public competition: "The local franchises, while having elements of property,
2 confer no contractual or property right to be free of competition either from individuals, other public
3 utility corporations, or the state or municipality granting the franchise." Id. at 139. "[F]reedom from
4 competition is not constitutionally protected." Law Motor Freight, Inc. v. Civil Aeronautics B'd,
5 364 F.2d 139, 144 (1st Cir. 1966). Market St. Ry. Co. v. R.R. Comm'n of Cal., 324 U.S. 548, 567
6 (1945)(The due process clause does not insure values or require restoration of values that have been
7 lost by operation of economic forces).^{2/}

8 Although Staff does not believe the utilities have a vested property right in guaranteed
9 cost recovery, the Staff acknowledges that both the Arizona and United States Constitutions prohibit
10 the government from taking private property without just compensation. U.S. Const. amend. V;
11 Ariz. Const. art. II, § 17. Although the United States Supreme Court has been unable to identify
12 any set formula to determine when justice and fairness require economic injuries caused by public
13 action to be compensated by the government, it has set forth certain factors to guide courts. The
14 Arizona courts look to those federal Supreme Court factors that set forth the standards for takings:

- 15 1. the economic impact of the regulation on the claimant (does the regulation
16 preclude all economically reasonable use of the property or just the most
17 beneficial use of the property?);
- 18 2. extent to which the regulation has interfered with distinct investment-
19 backed expectations;
- 20 3. the character of the governmental action;
- 21 4. whether health, safety, morals, or the general welfare is promoted;
- 22 5. whether there is a physical invasion of property by the government;
- 23 6. whether the interference arises from some public program adjusting
24 the benefits and burdens of economic life to promote the common
25 good.

25 ^{2/} Even assuming for purposes of argument there is some reduction in value, that does not mean that the
26 utilities necessarily have a right to compensation. The Commission also regulates the affected utilities under the police
27 power to protect consumers. Corp. Comm'n v. State ex rel. Woods, 171 Ariz. 286, 298, 830 P.2d 807, 819 (1992). In
28 Third & Catalina Associates v. City of Phoenix, 182 Ariz. 203, 208, 895 P.2d 115, 120 (1994), the Arizona Court of
Appeals indicated that private property may even be destroyed under the police power without compensation when
destruction is necessary to protect the public. Although the Catalina opinion addressed unsafe buildings that posed
health hazards, the police power was relied by the Court upon as the basis for action to protect the public. Similarly,
the Commission's regulation of the public utilities protects consumers. Woods, 171 Ariz. at 298, 830 P.2d at 819.

1 Laidlaw Waste Sys., Inc. v. City of Phoenix, 168 Ariz. 563, 566, 815 P.2d 932, 935 (App.
2 1991)(citing Ranch 57 v. City of Yuma, 152 Ariz. 218, 225, 731 P.2d 113, 120 (App. 1986)); Penn
3 Central Transp. Co. v. City of N.Y., 438 U.S. 104, 124-125, (1978)(citing Goldblatt v. Hempstead,
4 369 U.S. 590, 594, (1962)).

5 Cases decided after Penn Central identify three factors that are particularly
6 significant: 1) economic impact of the regulation; 2) extent to which the regulation has interfered
7 with distinct investment-backed expectations; and 3) the character of the governmental action. Cox
8 Cable Communications, Inc. v. United States, 866 F.Supp. 553, 559 (D.Ga. 1994) (citing Connolly
9 v. Pension Benefit Guar. Corp., 475 U.S. 211, 225 (1986) (quoting Penn Central 438 U.S. at 124);
10 see Keystone Bituminous Coal Assoc. v. De Benedictus, 480 U.S. 470, 501-02 (1987)(usually, a
11 regulation will be considered a taking only if it unjustly reduces the economic value of the property).

12 The Arizona Supreme Court has formulated a standard in order to determine when
13 an unconstitutional taking has occurred: "[t]o sustain an attack upon the validity of the ordinance
14 an aggrieved property owner must show that if the ordinance is enforced the consequent restrictions
15 upon his property preclude its use for any purpose to which it is reasonably adapted." City of
16 Phoenix v. Fehlner, 90 Ariz. 13, 19, 363 P.2d 607, 611 (1961) (quoting Arverne Bay Const. Co. v.
17 Thatcher, 278 N.Y. 222, 226, 15 N.E.2d 587, 589 (1938)(emphasis added)). The term "any
18 reasonable use" is interpreted as a use which is economically viable--one that allows a reasonable
19 return on the property. Ranch 57, 152 Ariz. at 227, 731 P.2d at 122.

20 In addition, the Supreme Court has distinguished between a partial taking and a full
21 taking of property. Andrus v. Allard, 444 U.S. 51, 65 (1979). If an owner has a full bundle of
22 property rights, the eradication of one strand of the bundle is not a taking because the aggregate must
23 be viewed in its entirety. Id. at 66. According to the Court, a loss of future profits which are not
24 accompanied by any physical restriction

25 provides a slender reed upon which to rest a takings claim. Prediction
26 of profitability is essentially a matter of reasoned speculation that
27 courts are not especially competent to perform. Further, perhaps
because of its very uncertainty, the interest in anticipated gains has
traditionally been viewed as less compelling than other property-
related interests.

28 Id. (emphasis added).

1 Arizona courts also look to the loss of profits when determining a taking. Although
2 the taking of intangible property has been recognized as compensable under the United States
3 Constitution, Arizona courts have been more reluctant to recognize business losses as compensable
4 property interests. Laidlaw, 168 Ariz. at 565, 815 P.2d at 934 (citing Choisser v. State ex rel.
5 Herman, 12 Ariz. App. 259, 261, 469 P.2d 493, 495 (1970)((citing State ex. rel. Herman v. Schaffer,
6 105 Ariz. 478, 467 P.2d 66 (1970))); State ex rel. LaPrade v. Carrow, 57 Ariz. 429, 433, 114 P.2d
7 891, 893 (1941). Loss of customers, business, or profits are non-compensable as independent items
8 of damages. Choisser 12 Ariz. at 261, 469 P.2d at 495 (citing Herman v. Schaffer 1905 Ariz. at 485,
9 467 P.2d at 73). Evidence of such losses is admissible only for the very limited purpose of tending
10 to show a *diminution* in the highest and best use of the property. Id. But evidence of loss of profits
11 standing alone will not establish any compensable damages. Id. “a ‘taking’ may more readily be
12 found when the interference with property can be characterized as a physical invasion by government
13 than when interference arises from some public program adjusting the benefits and burdens of
14 economic life to promote the common good.” Penn Central, 438 U.S. at 124.

15 The Penn Central factors generally involve ad hoc, factual inquiries. However, the
16 federal Supreme Court recognizes two situations in which a taking may be presumed: physical
17 invasion of property and denial of all economically beneficial or productive use of the property.
18 Lucas v. South Carolina Coastal Council, 505 U.S. 1003, 1015 (1992); Nollan v. California Coastal
19 Commission, 483 U.S. 825, 834 (1987); Dolan v. City of Tigard, 512 U.S. 374, 385 (1994). Neither
20 of these situations is presented by Staff’s recommendation that the utilities’ ratepayers not be held
21 as guarantors for recovery of 100% of uneconomic costs revealed by competition.

22 When all of the tests are applied to this proceeding, it is clear that the Commission
23 has not taken the utilities’ property if the utilities are at risk through mitigation for recovery of
24 uneconomic costs. a regulation will be considered a taking only if it unjustly reduces the economic
25 value of the property. Pa. Coal Co. v. Mahon, 260 U.S. 393, 413 (1922); Keystone Coal, 480 U.S.
26 at 485. Placing the utilities at risk for uneconomic costs does not preclude all economically
27 reasonable use of the property or even the most beneficial use of the property. On the contrary, the
28 opportunity to mitigate stranded cost recovery provides the utilities an opportunity to recover the

1 market value of their assets. What better measure of "fair value" can be found than in a competitive
2 environment? Thus, the utilities will be unable to establish that there has been any reduction in the
3 value of their property or assets, much less an unjust reduction in value. As discussed herein, the
4 utilities never had a guarantee of 100% recovery of their costs under traditional regulation. No such
5 guarantee is mandated in the transition to a competitive generation market. Merely because the
6 utilities will be at risk for recovery of uneconomic costs through mitigation does not mean the
7 utilities will be unable to recover their uneconomic costs.

8 Moreover, until the utilities have exhausted their opportunities to recover any
9 uneconomic costs through mitigation, they will be unable to establish a taking. "The law is well-
10 settled that claims under the Takings clause of the 5th Amendment are not ripe until the Plaintiffs
11 have been denied compensation." Pub. Serv. Comm'n of New Mexico v. City of Albuquerque, 755
12 F. Supp. 1494, 1498 (D.N.M. 1991). Placing the utilities at risk for recovery of stranded costs
13 through mitigation provides a procedure whereby the affected utilities may recover their stranded
14 costs. "If a State provides an adequate procedure for seeking just compensation, the property owner
15 cannot claim a violation of the Just Compensation Clause until it has used the procedure and been
16 denied just compensation." Williamson County Regional Planning Comm'n v. Hamilton Bank of
17 Johnson City, 473 U.S. 172, 195 (1985).

18 **III. STAFF'S POSITION ON THE SPECIFIC QUESTIONS POSED FOR THIS** 19 **PROCEEDING.**

20 Staff's position with respect to the questions posed for this proceeding was generally
21 identified in the "Stranded Cost Docket Issue Matrix" developed by the Residential Utility
22 Consumer Office. In light of the extent of the testimony offered in the hearing portion of this phase
23 of the proceeding, it is now possible to further summarize the impact of Staff's proposal in
24 connection with the questions posed. Accordingly, the following describes Staff's view of the
25 impact of our position, as presented in the testimony of Kenneth Rose, on the specific questions
26 posed for this proceeding.

27 ...

28 ...

1 a. Should the Electric Competition Rules Be Modified Regarding Stranded Costs?
2 If So, How?

3 Staff proposes to modify the rules in order to accomplish three goals: 1) clarify that
4 there is no guarantee of stranded cost recovery, 2) limit stranded cost recovery to minimize the
5 impact of recovery on the effectiveness of competition, and 3) clarify that the opportunity to recover
6 stranded costs should be the result of utility efforts to be more efficient.

7 The hearings in this proceeding have only served to reinforce the validity and
8 necessity of adopting Staff's approach. Legal arguments aside, none of the parties to the proceeding
9 presents a supportable case in favor of guaranteeing recovery of uneconomic costs. In fact, the
10 Affected Utilities find themselves in an untenable position as they attempt to justify a guarantee.
11 The legal requirement is the subject of pending litigation which, to date, has not resulted in any court
12 concluding that stranded cost recovery must or should be guaranteed. Attempts to reposition their
13 claim as a "moral" requirement are grounded in the identical arguments which form the basis of the
14 legal claim, (See Ex. TEP-1 at 26-27.) Staff would urge that the Commission disregard the
15 suggestion that recovery of uneconomic costs is a "moral" issue and rely instead on legal, economic
16 and regulatory standards in assessing whether to guarantee stranded cost recovery.

17 All of which leads to the most significant dilemma presented by the Affected
18 Utilities' position in support of guaranteeing recovery of uneconomic costs. That dilemma is
19 presented by the fact that traditional regulation doesn't provide guaranteed recovery for any cost.
20 The utilities do not explain why "stranded costs" should be granted a higher assurance of recovery
21 in the transition to a competitive market than those same costs would have enjoyed under continued
22 regulation. Lip service is paid to the notion that what the utilities seek is the opportunity to recover
23 stranded costs, but that lip service is belied by the proposals presented. Implementation of a "net
24 lost revenues" approach, for purposes of determining cost recovery, as presented by APS and TEP,
25 necessitates the leap of faith of assuming that it is possible to determine what revenues would have
26 occurred under the continuation of regulation. And while a true-up mechanism has the comforting
27 attribute of minimizing the risk of over-recovery, it acts as a guarantee of recovery, the likes of
28 which does not even occur under traditional regulation.

1 At their core, utility arguments against Staff's proposed amendment to the rules are
2 grounded in maintaining a guarantee of recovery, not a guaranteed opportunity to recover stranded
3 costs. Staff's proposed transition revenue approach provides more than adequate opportunity to
4 recover potentially uneconomic costs. Numerous parties introduced testimony explaining that a
5 guarantee of recovery will inhibit cost-cutting or otherwise fail to maximize the incentive towards
6 economic efficiency. Under Staff's proposal transition revenues will be allowed to ensure that
7 Commission established criteria are attained by the Affected Utilities. The utilities are provided
8 maximum incentive to operate efficiently, with a Commission established backstop to ensure that
9 financial viability is not sacrificed. None of the other proposals in this proceeding provides the
10 flexibility that Staff's proposal presents.

11 B. When Should "Affected Utilities" Be Required to Make a "Stranded Cost" Filing
12 Pursuant to A.A.C. R14-2-1607?

13 Staff continues to believe that stranded cost filings should be made within sixty days
14 after a decision is issued in this proceeding. The objective continues to be to allow utilities adequate
15 time to prepare such a filing, while providing adequate time for the Commission to process the
16 filings prior to January 1, 1999. Staff's proposed transition revenues approach is particularly well
17 suited to allowing the timely processing of stranded cost filings by the utilities. The focus in
18 stranded cost proceedings will be on the establishment of reasonable criteria to apply before allowing
19 transition revenues. Complex calculations and argument over estimation methodologies would be
20 of less consequence under Staff's proposal, allowing the utilities to spend their time preparing for
21 the advent of competition, rather than on devising estimation methodologies for a market value of
22 generation.

23 C. What Costs Should Be Included as Part of "Stranded Costs" and How Should Those
24 Costs Be Calculated?

25 Staff's presentation described the three types of uneconomic costs which are properly
26 includable as stranded cost: 1) "production costs" related to the generation of electricity, 2)
27 "regulatory assets", and 3) public policy obligations that a utility may have been required to support
28 by state or federal law or regulation. We advocate a "top-down" approach to the calculation.

1 projecting the net present value of the difference between generation revenues that would be received
2 if traditional regulation continued and the projected revenue expected under competition.

3 It is important to recognize the distinction between the adoption of a method to
4 calculate stranded costs and the consideration of a method of recovery. Staff's proposed "top-down"
5 calculation methodology is very similar to the calculation methodology suggested by parties
6 sponsoring a "net revenues lost" approach to stranded cost recovery. Stranded cost calculations
7 under Staff's proposal would suffer the same types of infirmities as the calculations made to support
8 a net revenues lost approach. The difference is that Staff's approach does not rely on the calculation
9 of uneconomic costs as a mechanism to establish recovery levels. The recovery levels are solely
10 determined by reference to Commission established criteria to meet financial or other requirements.
11 Accordingly, the stranded cost calculations are only a "reference point", useful as a general guide
12 for considering a utility's competitive situation, but not directly related to stranded cost recovery
13 levels.

14 Again, Staff's proposal provides the opportunity for flexibility in maintaining a
15 utility's financial viability in a competitive market, while minimizing distortions to the economic
16 incentives. Staff's proposal is also preferable to methods requiring sale or auction of generation
17 assets. Sale or auction methodologies do not provide actual benefits to consumers. The reason is
18 that the sale, even if it results in a price greater than book value, will only result in the acquiring
19 entity attempting to recover its total investment. In the context of traditional regulation, this is
20 analogous to the situation where an asset is subject to an acquisition adjustment. To the extent the
21 market permits recovery of the above book cost, consumers pay by means of higher generation costs
22 instead of through stranded cost recovery. Staff's transition revenues approach leaves the
23 uneconomic costs in a position to be identified as such, and allows recovery where appropriate.

- 24 1. What is the recommended calculation methodology and assumptions made
25 including any determination of market clearing price?

26 Staff's proposal is not dependent on the accuracy of the calculation methodology and
27 assumptions made as to market clearing price. We offered no specific proposals as to assumptions.
28 Our recommendation is that the Commission consider at least two separate price scenarios, so that

1 a clearer picture of the overall impact of any transition revenues allowed can be assessed. In
2 addition, consistent with the position taken by several other parties, (See Ex. AECC-4 at 10), Staff
3 supports the use of retail, rather than wholesale prices in projecting stranded cost scenarios. The lack
4 of reliance on the accuracy of price projections is a significant advantage of Staff's proposal over
5 all others in this proceeding.

6 2. What are the implications of the Statement of Financial Accounting
7 Standards No. 71 resulting from the recommended stranded cost calculation
8 and recovery methodology?

8 The implications of SFAS 71 are not determinable until the regulated cash flows of
9 a utility are established, and are compared with cash outflows. Under Staff's proposal the accounting
10 implications are unknown until the Commission establishes criteria to be applied to the requirement
11 for transition revenues. Accordingly, the potential impacts of SFAS 71 can be assessed in
12 connection with a utility's stranded cost filing which follows this proceeding. Staff's proposal,
13 therefore, has the advantage of permitting the Commission to examine the effects of accounting
14 standards on the affected utility in advance of a final determination of stranded cost recovery levels.
15 By contrast, a specific decision to allow a specified percentage of stranded cost recovery in this
16 proceeding could have unintended consequences with respect to the effects of accounting standards
17 on the Affected Utilities.

18 D. Should There Be a Limitation on the Time Frame over Which "Stranded Costs" Are
19 Calculated?

20 Stranded costs should be calculated over, at most, the expected life of the generation
21 assets, taking care not to add in new capital additions. Since Staff's recovery proposal is not
22 dependent on the specific calculation of uneconomic costs, the primary benefit associated with an
23 accurate calculation methodology is that the nature and extent of uneconomic costs are placed in
24 appropriate context. Additionally, a reasonable calculation methodology should be employed to
25 ensure that the transitions revenue approach is only implemented to address actual uneconomic costs
26 resulting from the transition to competition, as opposed to any other conditions which might impact
27 the financial condition of an affected utility.

28 ...

1 E. Should There Be a Limitation on the Recovery Time Frame for "Stranded Costs"?

2 Staff's proposal is that any stranded cost recovery permitted should take place over
3 a short a time period. Specifically, we proposed a time frame of five years or less, which
4 corresponds with the recommendations of many other parties. Staff's proposed time period is
5 intended to minimize distortions in the development of a competitive market and to recognize that
6 the purpose of stranded cost recovery is to provide a transition from the current monopoly market
7 to competition. That transition should be complete in five years or less.

8 F. How and Who Should Pay for "Stranded Costs" and Who, If Anyone, Should Be
9 Excluded from Paying for Stranded Costs?

10 Staff believes that, to the extent transition revenues are allowed, they should be
11 recoverable through a non-bypassable customer charge during the transition period, in the form of
12 a surcharge added to the distribution charge. This proposal is consistent with the proposal of the vast
13 majority of participants in the proceeding.

14 G. Should There Be a True-up Mechanism And, If So, How Would it Operate?

15 Whether a true-up mechanism is necessary is dependent on whether the Commission
16 authorizes recovery of transition revenues for any Affected Utility to recover uneconomic costs. If
17 no transition revenues are allowed, obviously no true-up mechanism is necessary. The closer the
18 amount of transition revenues allowed for recovery is to the estimate of uneconomic costs, the
19 greater the need for a true-up mechanism in order to avoid the possibility of over-recovery by an
20 Affected Utility. Under any scenario, the stranded cost calculation is necessarily an estimate. Since
21 Staff's proposed transition revenue approach is not explicitly tied to any estimate of uneconomic
22 cost, and is not based on full recovery, a true-up mechanism may not be necessary to ensure that the
23 transition revenue allowance did not exceed actual stranded costs during the transition period.

24 H. Should There Be Price Caps or a Rate Freeze Imposed as Part of the Development
25 of a Stranded Cost Recovery Program and If So, How Should it Be Calculated?

26 Staff continues to support the imposition of a price cap to guard against the unbundled
27 rates of a utility totaling more than the standard offer. Such a cap should only exist while transition
28 revenues are being collected from customers. Staff does not support a rate freeze, since a rate freeze

1 would limit the downward mobility by which rates could be adjusted to capture benefits from cost
2 reductions.

3 I. What Factors Should Be Considered for "Mitigation" of Stranded Costs?

4 Under Staff's proposed transition revenues approach, there is no need to calculate a
5 "mitigated" stranded cost amount. Staff's proposal provides appropriate incentives to the Affected
6 Utilities to mitigate their stranded costs by only allowing transition revenues, if at all, in an amount
7 necessary to meet Commission established criteria. The less transition revenues allowed, the greater
8 the incentive to mitigate. Allowance of no transition revenues would maximize the incentive for the
9 utilities to mitigate their stranded costs.

10 **IV. THE FUTURE.**

11 The current proceeding is only the next step in implementing the Commission's
12 Retail Electric Competition Rules. Staff's proposed transition revenues approach is readily
13 translated into the next stages of the roadmap towards implementation. As indicated in our specific
14 responses to the questions presented in this proceeding, Staff suggests that "stranded" cost filings
15 be required on the part of all Affected Utilities within sixty days of the issuance of an Order in this
16 proceeding. The processing of those filings will provide the next major step in the process.

17 The filings should include sufficient information for the Commission to assess each
18 affected utility's situation regarding the need and desirability of transition revenue allowance. The
19 first thing that should be included, then, is the utility's calculation of its potentially uneconomic
20 costs. Under Staff's proposal, each utility would provide a "top-down" estimate of its uneconomic
21 costs. This estimate would consist of projections of the net present value of the difference between
22 the generation revenues that the utility would receive if traditional regulation continued and the
23 projected revenues expected with competition, over the expected life of the utility's generation
24 assets. The projections should isolate potential uneconomic costs as either production costs,
25 regulatory assets or public policy obligations. Consistent with Staff's recommendation, each utility
26 should be required to provide at least two price scenarios under competition and should require
27 estimation of retail, rather than wholesale prices.

28 ...

1 Each utility's stranded cost filing should be required to provide its suggested
2 Commission criteria for the allowance of transition revenues. The utilities should be prohibited from
3 presenting scenarios which guarantee full stranded cost recovery or including criteria specifically
4 tied to a "regulatory compact" theory of stranded cost recovery. Specific criteria could, however,
5 be related to such potential issues as the potential impacts of SFAS 71 or other accounting standards.

6 Each utility's filing should include specific information comparing its projections
7 against its proposed criteria for the implementation of transition revenues. Included in the filing
8 should be a specific proposal for a recovery mechanism, if transition revenues are allowed.
9 Specifically, the utility should identify the basis for recovery, from all customers in a non-bypassable
10 manner, including specific representation of the amount and nature of the charge to be imposed if
11 the utility's scenario is adopted. Projected recovery periods should not exceed five years.

12 The Order in this proceeding should include direction to Staff to submit appropriate
13 rules changes to the Secretary of State, commencing the process of rule adoption for the requisite
14 amendments to the rules. Adoption of any changes on an emergency basis, followed by the process
15 necessary for permanent adoption, may be appropriate. The specific rule changes that are proposed
16 are contained in Ex. S-1, Attachment 1, as amended at Tr. at 3068-69.

17 The Order should provide the general outline of procedural dates for completion of
18 the stranded cost proceedings. Tentative dates for the filing of responsive testimony, rebuttal by the
19 utility, surrebuttal and tentative hearing dates should be included.

20 All of these elements should address the significant issues relating to stranded cost
21 calculation and potential recovery in support of the Commission's continuing implementation of its
22 Electric Competition Rules. Concurrently, Staff will be examining issues surrounding the approval
23 of unbundled tariffs for the Affected Utilities, and the consideration of applications for Certificates
24 of Convenience and Necessity on the part of potential electric service providers. Staff anticipates
25 the completion of these elements of implementation by approximately August 1998, in anticipation
26 of further market-structure proceedings, all geared towards a January 1, 1999 introduction of
27 competition in the generation of electricity.

28 ...

1 V. CONCLUSION.

2 Staff's proposed transition revenues approach has significant advantages over the
3 other proposals provided in this proceeding. Among those advantages are the following: 1)
4 maximizes utilities' incentive to mitigate stranded costs, 2) minimizes the impact of stranded cost
5 recovery as a distortion to the development of the competitive electric generation market, 3)
6 minimizes the importance of stranded cost calculations, with all the inherent assumptions and
7 complexities, on stranded cost recovery, 4) is consistent with the Commission's timetable for
8 introducing competition on January 1, 1999, 5) provides an opportunity for recovery of uneconomic
9 costs without guaranteeing such, 6) allows consideration of potential SFAS 71 or other accounting
10 considerations in an appropriate time frame, and 7) eliminates the need for potentially protracted
11 proceedings to examine mitigation efforts and adjust true-up mechanism. Staff requests that its
12 recommendations be adopted.

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

14
15 By: Paul A Bullis
16 Paul A. Bullis
17 Christopher C. Kempley
18 Janice Alward
19 Legal Division
20 1200 West Washington
21 Phoenix, Arizona 85007
22 (602) 542-3402
23
24
25
26
27
28

1
2
3
4
5
6
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8
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14
15
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19
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22
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24
25
26
27
28

Original and ten copies of the foregoing filed this 16th day of March, 1998 with:

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Copies of the foregoing provided this 16th day of March, 1998 to attached service list:

1 Service List:

2 Barbara Klemstine
ARIZONA PUBLIC SERVICE CO.
3 Law Department, Station 9909
P.O. Box 53999
4 Phoenix, Arizona 85072-3999

5 Greg Patterson
RUCO
6 2828 N Central Ave, Suite 1200
Phoenix, Arizona 85004

7
8 Michael A. Curtis
MARTINEZ & CURTIS, P.C.
2712 North 7th Street
9 Phoenix, Arizona 85006
Attorneys for Arizona Municipal Power Users' Association

10
11 Walter W. Meek, President
ARIZONA UTILITY INVESTORS ASSOCIATION
2100 N. Central Avenue, Suite 210
12 Phoenix, Arizona 85004

13 Rick Gilliam
LAND AND WATER FUND OF THE ROCKIES
14 2260 Baseline Road, Suite 200
Boulder, Colorado 80302

15
16 Charles R. Huggins
ARIZONA STATE AFL-CIO
110 North 5th Avenue
17 Phoenix, Arizona 85002

18 David C. Kennedy
LAW OFFICES OF DAVID C. KENNEDY
19 100 West Clarendon Avenue, Suite 200
Phoenix, Arizona 85012-3525

20
21 Norman J. Furuta
DEPARTMENT OF THE NAVY
900 Commodore Drive, Building 107
22 P.O. Box 272 (Attn. Code 90C)
San Bruno, California 94066-0720

23
24 Thomas C. Horne
Michael S. Dulberg
HORNE, KAPLAN & BISTROW, P.C.
25 40 North Central Avenue, Suite 2800
Phoenix, Arizona 85004

26
27 Barbara S. Bush
COALITION FOR RESPONSIBLE ENERGY EDUCATION
315 West Riviera Drive
28 Tempe, Arizona 85252

Rick Lavis
ARIZONA COTTON GROWERS ASSOCIATION
4139 East Broadway Road
Phoenix, Arizona 85040

Steve Brittle
DON'T WASTE ARIZONA, INC.
6205 South 12th Street
Phoenix, Arizona 85040

Karen Glennon
19037 N. 44th Avenue
Glendale, Arizona 85308

COLUMBUS ELECTRIC COOPERATIVE, INC.
P.O. Box 631
Deming, New Mexico 88031

CONTINENTAL DIVIDE ELECTRIC COOPERATIVE
P.O. Box 1087
Grants, New Mexico 87020

DIXIE ESCALANTE RURAL ELECTRIC ASSOCIATION
CR Box 95
Beryl, Utah 84714

GARKANE POWER ASSOCIATION, INC.
P.O. Box 790
Richfield, Utah 84701

Stephen Ahearn
ARIZONA DEPT OF COMMERCE
ENERGY OFFICE
3800 North Central Avenue, 12th Floor
Phoenix, Arizona 85012

Betty Pruitt
ARIZONA COMMUNITY ACTION ASSOC.
202 E. McDowell, #255
Phoenix, Arizona 85004

Bradley Carroll
TUCSON ELECTRIC POWER CO.
P.O. Box 711
Tucson, Arizona 85702

Mick McElrath
CYPRUS CLIMAX METALS CO.
P.O. Box 22015
Tempe, Arizona 85285-2015

1 A.B. Beardson
 NORDIC POWER
 2 4281 N. Summerset
 Tucson, Arizona 85715

3
 4 Michael Rowley
 c/o CALPINE POWER SERVICES
 50 West San Fernando, Suite 550
 5 San Jose, California 95113

6 Dan Neidlinger
 3020 N. 17th Drive
 7 Phoenix, Arizona 85015

8 Jessica Youle
 PAB300
 9 SALT RIVER PROJECT
 P.O. Box 52025
 10 Phoenix, Arizona 85072-2025

11 Clifford Cauthen
 GRAHAM COUNTY ELECTRIC CO-OP
 12 P.O. Drawer B
 Pima, Arizona 85543

13
 14 Joe Eichelberger
 MAGMA COPPER COMPANY
 P.O. Box 37
 15 Superior, Arizona 85273

16 Craig Marks
 CITIZENS UTILITIES COMPANY
 17 2901 N. Central Avenue, Suite 1660
 Phoenix, Arizona 85012

18 Jack Shilling
 19 DUNCAN VALLEY ELECTRIC COOPERATIVE
 P.O. Box 440
 20 Duncan, Arizona 85534

21 Nancy Russell
 ARIZONA ASSOCIATION OF INDUSTRIES
 22 2025 N. 3rd Street, Suite 175
 Phoenix, Arizona 85004

23 Barry Huddleston
 24 DESTEC ENERGY
 P.O. Box 4411
 25 Houston, Texas 77210-4411

26 Steve Montgomery
 JOHNSON CONTROLS
 27 2032 West 4th Street
 Tempe, Arizona 85281

28

Michelle Ahlmer
 ARIZONA RETAILERS ASSOCIATION
 137 University
 Mesa, Arizona 85201

Ken Saline
 K.R. SALINE & ASSOCIATES
 160 N. Pasadena
 Suite 101
 Mesa, AZ 85201

Louis A. Stahl
 STREICH LANG
 2 North Central Avenue
 Phoenix, Arizona 85004

Douglas Mitchell
 SAN DIEGO GAS AND ELECTRIC CO.
 P.O. Box 1831
 San Diego, California 92112

Sheryl Johnson
 TEXAS-NEW MEXICO POWER CO.
 4100 International Plaza
 Fort Worth, Texas 76109

Ellen Corkhill
 AARP
 5606 North 17th Street
 Phoenix, Arizona 85016

Andrew Gregorich
 BHP COPPER
 P.O. Box M
 San Manuel, Arizona

Larry McGraw
 USDA-RUS
 6266 Weeping Willow
 Rio Rancho, New Mexico 87124

Jim Driscoll
 ARIZONA CITIZEN ACTION
 2430 S. Mill, Suite 237
 Tempe, Arizona 85282

William Baker
 ELECTRICAL DISTRICT NO. 6
 P.O. Box 16450
 Phoenix, Arizona 85011

1 John Jay List
General Counsel
2 NATIONAL RURAL UTILITIES
COOPERATIVE FINANCE CORP.
3 2201 Cooperative Way
Herndon, Virginia 21071
4
5 Wallace Tillman
Chief Counsel
6 NATIONAL RURAL ELECTRIC
COOPERATIVE ASSOCIATION
4301 Wilson Blvd.
7 Arlington, Virginia 22203-1860
8 Robert Julian
PPG
9 1500 Merrell Lane
Belgrade, Montana 59714
10
11 C. Webb Crockett
FENNEMORE CRAIG
3003 N. Central Avenue, Suite 2600
12 Phoenix, Arizona 85012-2913
Attorneys for Asarco, Inc., Cyprus Climax Metals Co.,
13 Enron, Inc. and AAEC
14 Department of Navy
Naval Facilities Engineering Command
15 Navy Rate Intervention
901 M Street SE, Building 212
16 Washington, DC 20374
Attn: Sam DeFrawi
17 Robert S. Lynch
340 E. Palm Lane, Suite 140
18 Phoenix, Arizona 85004-4529
19 Douglas A. Oglesby
Vantus Energy Corporation
20 353 Sacramento Street, Suite 1900
San Francisco, California 94111
21 Michael Block
Goldwater Institute
22 Bank One Center
201 North Central
23 Concourse Level
Phoenix, Arizona 85004
24 Stan Barnes
Copper State Consulting Group
25 100 W Washington Street, Suite 1415
Phoenix, Arizona 85003
26
27
28

Carl Robert Aron
Executive Vice President and COO
Itron, Inc.
2818 N. Sullivan Road
Spokane, Washington 99216

Douglas Nelson
DOUGLAS C NELSON PC
7000 N. 16th Street, Suite 120-307
Phoenix, Arizona 85020

Lawrence V. Robertson Jr.
MUNGER CHADWICK PLC
333 North Wilmot, Suite 300
Tucson, Arizona 85711-2634
Attorney for PGE Energy

Tom Broderick
6900 East Camelback Rd. # 700
Scottsdale, Arizona 85251

Albert Sterman
ARIZONA CONSUMERS COUNCIL
2849 East 8th Street
Tucson, Arizona 85716

Michael Grant
GALLAGHER & KENNEDY
2600 N. Central Avenue
Phoenix, Arizona 85004
Attorneys for AEPCO

Suzanne Dallimore
Antitrust Unit Chief
Department of Law Building
Attorney General's Office
1275 West Washington Street
Phoenix, Arizona 85007

Lex Smith
Michael Patten
BROWN & BAIN PC
2901 N. Central Avenue
Phoenix, Arizona 85001-0400
Attorneys for Morenci Water & Electric,
Ajo Improvement & Phelps Dodge Corp.

Vinnie Hunt
CITY OF TUCSON
Department of Operations
4004 S. Park Avenue, Building #2
Tucson, Arizona 85714

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28

Steve Wheeler
Thomas M. Mumaw
SNELL & WILMER
One Arizona Center
400 E. Van Buren Street
Phoenix, Arizona 85004-0001
Attorneys for APS

William Sullivan
MARTINEZ & CURTIS, P.C.
2716 N. 7th Street,
Phoenix, Arizona 85006
Attorneys for Mohave Electric Cooperative and
Navopache Electric Cooperative

Elizabeth S. Firkins
INTERNATIONAL BROTHERHOOD OF
ELECTRICAL WORKERS, L.U. #1116
750 S. Tucson Blvd.
Tucson, Arizona 85716-5698

Carl Dabelstein
2211 E. Edna Avenue
Phoenix, Arizona 85022

Larry K. Udall
Arizona Municipal Power Users' Assoc.
2712 N. 7th Street
Phoenix, Arizona 85006-1090

Roderick G. McDougall
City Attorney
Attn: Jesse Sears, Assistant Chief Counsel
200 W Washington Street, Suite 1300
Phoenix, Arizona 85003-1611

William J. Murphy
200 W Washington Street, Suite 1400
Phoenix, Arizona 85003-1611

Terry Ross
Center for Energy & Economic Development
P. O. Box 288
Franktown, Colorado 80116

Peter Glaser
Doherty Rumble & Butler PA
1401 New York Ave NW Suite 1100
Washington DC 20005

By: *Mary Spolits*

Russell E. Jones
33 N. Stone Ave., Suite 2100
P.O. Box 2268
Tucson, Arizona 85702

Christopher Hitchcock
P.O. Box 87
Bisbee, Arizona 85603-0087
Attorneys for Sulphur Springs Valley
Electric Cooperative, Inc.

Myron L. Scott
1628 E. Southern Avenue, No. 9-328
Tempe, AZ 85282-2179
Attorneys for Arizona for a Better Environment

Andrew Bettwy
Debra Jacobson
SOUTHWEST GAS CORPORATION
5241 Spring Mountain Road
Las Vegas, Nevada 89102

Barbara R. Goldberg
OFFICE OF THE CITY ATTORNEY
3939 Civic Center Blvd.
Scottsdale, Arizona 85251

Phyllis Rowe
Arizona Consumers Council
P. O. Box 1288
Phoenix, Arizona 85001

Thomas Pickrell
Arizona School Board Association
2100 N. Central Avenue
Phoenix, Arizona 85004

SUPERIOR COURT OF ARIZONA
MARICOPA COUNTY

CLERK OF THE COURT

November 19, 1997

HON. COLIN F. CAMPBELL

E. Schneider
Deputy

№ CV 97-03748 (Consolidated)

FILED: _____

TUCSON ELECTRIC POWER CO.

Raymond S. Heyman

v.

Beth Ann Burns

THE ARIZONA CORPORATION
COMMISSION, et al.

Bradley S. Carroll (Tucson)

Lindy Funkhouser

Lawrence V. Robertson, Jr.

Kenneth C. Sundlof, Jr.

Jane D. Alfano

Douglas C. Nelson

Louis A. Stahl

Lex J. Smith

Hon. B. Michael Dann
(CV 97-03920 and CV 97-03922)

The Court previously heard oral argument on cross-motions for summary judgment and took the matter under advisement pending a ruling by Presiding Civil Judge Kaufman as to consolidation of related cases. Judge Kaufman ruled on the consolidation issues on November 12, 1997.

Plaintiff Tucson Electric Power Company ("TEP") filed for summary judgment asking that the Court declare that the competition rules issued by the Arizona Corporation Commission breaches a regulatory contract with TEP, unlawfully confiscates TEP property without due process of law, and violates the Administrative Procedures Act. Defendant the Arizona Corporation Commission

SUPERIOR COURT OF ARIZONA
MARICOPA COUNTY

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E. Schneider
Deputy

No. CV 97-03748 (Consolidated)

TUCSON ELECTRIC V. ARIZONA CORPORATION COMMISSION

Continued

cross-moves for summary judgment. Separate briefs and cross-motions have been filed by numerous intervenors. The issues in this case have been exceptionally well-briefed by counsel.

The history of electrical regulation in Arizona, and the events leading to the promulgation of the new competitive rules, are well covered in the briefs filed by the parties and intervenors. Under the new rules, the Corporation Commission has announced that commencing in 1999, under a phase-in schedule, electrical rates will be set competitively. The Court notes that the competition rules are not yet complete; indeed, the rule-making process here seems akin to fast track construction. Although the Commission has announced a time for transition to a competitive marketplace in electricity, working groups are recommending additional rules to effectuate the transition. The incompleteness of the rules raise issues of ripeness as set out below.

(A) Can the Corporation Commission Switch from a Regulated Monopoly to Competition?

TEP argues that the Corporation Commission cannot unilaterally modify or abrogate the so-called regulatory contract embodied in the certificate of convenience and necessity between TEP and the State. Although the parties devote countless pages of their briefs to discussing the effect of a certificate of convenience and necessity under A.R.S. §40-281, the Court believes this issue is controlled by A.R.S. §40-252.

By A.R.S. §40-252, the Commission may at any time upon notice to a public service corporation and after opportunity to be heard rescind, alter or amend any order or decision made by it. We have said that Arizona is a regulated monopoly state and that "The monopoly is tolerated only because it is to be subject to vigilant and continuous regulation by the Corporation Commission, and is subject to rescission, alteration or amendment at any time upon proper notice when the public interest would be served by such action."

SUPERIOR COURT OF ARIZONA
MARICOPA COUNTY

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TUCSON ELECTRIC V. ARIZONA CORPORATION COMMISSION

Continued

Arizona Corporation Commission v. Arizona Water Co., 111 Ariz. 74 (1974), citing Davis v. Corporation Commission, 96 Ariz. 215 (1964).

Here, the Arizona Corporation Commission can rescind TEP's certificate of convenience and necessity by complying with A.R.S. §40-252. It is not clear to the Court whether a section 40-252 hearing has been held. The Commission has provided notice and an opportunity to be heard to TEP upon a policy change in the future initiated by rule that would allow rates to be set competitively rather than through regulated pricing. These rules will implicitly rescind parts of TEP's certificate of convenience and necessity. Until these rules become effective, however, TEP continues to operate under its certificate of convenience and necessity.

On the undisputed facts before the Court, there is no question that competitive pricing of electricity would benefit the public interest. See, Intervenor Arizona Association of Industries' Memorandum in Opposition to Plaintiff's Motion for Summary Judgment, dated August 1, 1997 (discussion of benefits of competitive pricing). The Court unequivocally rejects TEP's suggestion that the Corporation Commission cannot rescind, alter or amend any certificate of convenience and necessity to allow for the competitive pricing of electrical energy. A regulated monopoly is not a vested property right and it can be changed by the Corporation Commission if the public interest is furthered.

It is not clear to the Court, however, whether the notice and opportunity hearing allowed by A.R.S. §40-252 to TEP has been started or, if the rule making process is the section 40-252 hearing, whether it has been completed. Although the policy decision to switch from monopoly to competition has been made, working groups are still recommending rules regarding the transition to competition. These working groups will make vital decisions to TEP, such as rules regarding stranded costs discussed below.

SUPERIOR COURT OF ARIZONA
MARICOPA COUNTY

CLERK OF THE COURT

November 19, 1997

HON. COLIN F. CAMPELL

E. Schneider
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TUCSON ELECTRIC V. ARIZONA CORPORATION COMMISSION

Continued

TEP argues that the Commission must strictly comply with A.R.S. §40-252 before its certificate of necessity and convenience can be revoked. See Application of Trico Elec. Co-op, Inc., 92 Ariz. 373 (1962). TEP complains that the Commission has announced its intent to rescind its certificate in the future, but has not yet completed hearings. If the hearing requirements of section 40-252 has not yet been started or completed, then TEP may have a colorable argument that the competition rules should be enjoined until the hearing is completed. The Court will request additional briefing on this issue.

(B) Do the Commission Rules Constitute a Taking of Property?

The Court rejects above any argument that TEP has a property right to a monopoly itself. TEP argues, however, another kind of taking. Under its certificate of convenience and necessity, TEP has invested monies for electrical generation and distribution of electricity in its service area. Under a regulated monopoly, TEP recovers these costs through regulated pricing. TEP argues that the competition rules may set electrical prices at a level that will not allow TEP to recover these costs, which the parties therefore call "stranded costs." If the competition rules do not allow TEP to recover these stranded costs, then TEP argues the rules create an unconstitutional taking of its property.

The brief filed by the Mining and Affected Utility Intervenor's (July 25, 1997 at pp. 9 et. seq.), addresses whether a change in regulation, even if it impacts a corporation's value, is a "taking" in the constitutional sense. The Court need not reach this issue, however, because here the Corporation Commission rules do allow for recovery of stranded costs. Whether a constitutional challenge can be made is premature and not ripe for decision until the Commission acts upon TEP's claim for stranded costs under its rules, which are not completed. On this record, it is not certain whether TEP will have any claimed "taking" at all.

(C) Was the Administrative Procedure Act Violated?

SUPERIOR COURT OF ARIZONA
MARICOPA COUNTY

CLERK OF THE COURT

November 19, 1997

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E. Schneider
Deputy

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TUCSON ELECTRIC V. ARIZONA CORPORATION COMMISSION

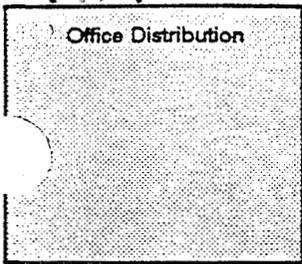
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TEP argues that the Commission materially and substantially changed a portion of the competition rules concerning municipal corporations without republishing the rules in violation of A.R.S. §41-1025. TEP also argues the rules have to be submitted to the Attorney General under A.R.S. §41-1044.

The Court concludes that the noticed and adopted rule address the same subject matter and issues and have the same effect. They are not substantially different under the test set forth in A.R.S. §41-1025(B). The Court accepts and adopts the analysis set forth in SRP's Response to Motion for Summary Judgment, filed July 25, 1997. Moreover, the competition rules are rate-making rules and not subject to Attorney General approval. See State ex rel. Corbin v. Arizona Corporation Commission, 174 Ariz. 216 (App. 1993). Accordingly,

IT IS ORDERED:

1. The parties will submit further briefing regarding the relationship between A.R.S. §40-252 and the competition rules and the Commission's announced intention to terminate TEP's certificate of convenience and necessity in the future.
2. TEP's motion for summary judgment insofar as it seeks a ruling that the Commission cannot as a matter of contract change from a regulated marketplace to a competitive marketplace is denied. Cross-motions for summary judgment on this issue are granted.
3. TEP's motion for summary judgment on the issue of unconstitutional taking is ruled premature and not ripe for review, Cross-motions raising the issue of ripeness are granted.
4. TEP's motion for summary judgment on the issue of violation of the Administrative Procedure Act is denied. Cross-motions on this issue are granted.



SUPERIOR COURT OF ARIZONA
MARICOPA COUNTY

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L CLERK OF THE COURT J

January 16, 1998

HON. B. MICHAEL DANN

S. Nielsen
Deputy

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ARIZONA ELECTRIC v. ARIZONA CORPORATION COMM'N

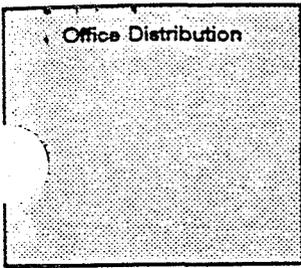
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The Arizona Corporation Commission ("ACC"), have been under advisement since oral argument by counsel on December 11, 1997. I have read and considered the parties' memoranda and the pertinent factual material attached.

IT IS ORDERED denying the plaintiffs' motions for summary judgment and granting the ACC's cross-motion for summary judgment for the reasons discussed below.

Plaintiffs challenge the ACC's authority to promulgate and the constitutionality of A.A.C. R14-2-1601, *et seq.*, Commission rules which establish "a framework for introducing competitive pricing...for electric generation in Arizona." (ACC Memorandum, at 2) More specifically,

The Rules restructure Arizona's retail market for electric generation. The Rules effect a public policy change for rate regulation of Arizona utilities: until now, the Commission has set rates and provided cost recovery through a system of regulated pricing; in future, the Commission will permit rates to be set competitively and will provide cost recovery for certain uneconomic assets that may result from pricing reform. Traditionally, electric utilities have priced electric generation, transmission, and distribution services at a single rate in a "bundled" transaction. The Rules will require electric utilities to "unbundle" pricing of these elements so



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S. Nielsen
Deputy

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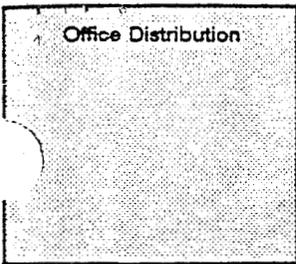
ARIZONA ELECTRIC v. ARIZONA CORPORATION COMM'N

Continued

that generation will be priced in the market. A.A.C. R14-2-1606(C). A customer will be able to choose among multiple providers for generation service. Affected utilities will accept power from competitive generators for distribution to consumers. A.A.C. R14-2-1606(E).

The Rules phase in competition: in 1999, affected utilities must make at least twenty percent of 1995 system retail peak demand available for competitive generation supply; in 2001, fifty percent must be available; finally, in 2003, one hundred percent must be available. A.A.C. R14-2-1604. Affected utilities will continue to offer bundled service until the Commission determines that competition has been substantially implemented. A.A.C. R14-2-1606(A). [*Id.* at 2-3]

With respect to the plaintiffs' arguments regarding lack of legal authority to make these rules and the constitutionality of them, the briefs filed by the ACC and by intervenors Arizona Association of Industries and Arizona Mining Association, et al, have the better of it. I adopt their arguments and authorities as those of the court's in rejecting



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HON. B. MICHAEL DANN

S. Nielsen
Deputy

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ARIZONA ELECTRIC v. ARIZONA CORPORATION COMM'N

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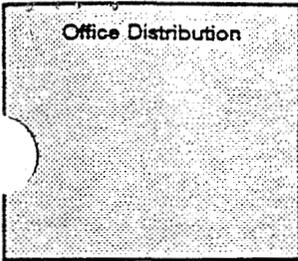
plaintiffs' challenges to the Commissions new rules.¹

Plaintiffs' principal constitutional and statutory concerns can be disposed of as follows:

1. Plaintiffs present rights, represented by CC&N's, do not amount to vested contract or other property rights:

A.R.S. § 40-281 provides only for certificates of convenience and necessity ("CC&Ns"). These do not constitute bilateral contracts between plaintiffs and the State. Rather, the statute implements Art. XV, Sec. 3 of the Arizona Constitution and the declared public policy choice of regulated monopoly in the governance of public utilities. *Arizona Corp. Comm'n. v. Superior Court*, 105 Ariz. 56, 59, 459 P.2d 489, 492 (1969); *Winslow Gas Co. v. Southern Union Gas Co.*, 76 Ariz. 383, 385, 265 P.2d 442, 443 (1954). There is no

¹One exception is their argument that plaintiffs' attacks on the new rules are premature. Although the Commission's work on the issues posed by partial deregulation is still ongoing, and the parties, including the plaintiffs, are at the table working out the many final details, the fact remains that the challenged rules, the necessary first step, represent a final legal determination by the Commission subject to legal review. Compare *Kunkel Transfer and Storage Co. v. Superior Court*, 22 Ariz. App. 315, 526 P.2d 1270 (App. 1974). Moreover, the Commission contends that the rules under consideration are rate making rules. I agree. Rate making orders are routinely appealed to superior court. See, e.g., *Corporation Commission v. State ex rel. Woods*, 171 Ariz. 286, 830 P.2d 807 (1992); *Tucson Elec. Power Co. v. Ariz. Corp. Comm'n.*, 132 Ariz. 240, 645 P.2d 231 (1982).



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MARICOPA COUNTY

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January 16, 1998

HON. B. MICHAEL DANN

S. Nielsen
Deputy

Nº CV 97-03920 CV 97-03921 CV 97-03922 CV 97-03928 CV 97-03942 CONSOL.

ARIZONA ELECTRIC v. ARIZONA CORPORATION COMM'N Continued

vested property right to continue to provide electric power in any particular way.

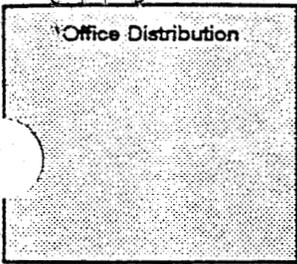
2. The Commission has plenary power to establish methods of setting rates; just as it has done here:

To say, as plaintiffs do, that only the Legislature can change the public policy of "regulated monopoly" to a competitive market ignores the broad powers given the Commission by Art. XV, Sec. 3 of the Constitution:

[t]he Corporation Commission shall have full power to, and shall, prescribe just and reasonable classifications to be used and just and reasonable rates and charges to be made and collected, by public service corporations within the State for service rendered therein, and make reasonable rules, regulations, and orders, by which such corporations shall be governed in the transaction of business within the State....

As stated by one of the intervenors:

Thus, the Commission's ratemaking power goes beyond strictly setting rates and charges in a rate case - it includes adoption of rules that (i) prescribe classifications for ratemaking and (ii) establish methods that will be used to determine rates for those classifications. See *Consolidated Water Util. Ltd. v. Arizona Corp. Comm'n*, 178 Ariz. 478, 483-84, 875 P.2d 137, 142-43 (Ct. App.



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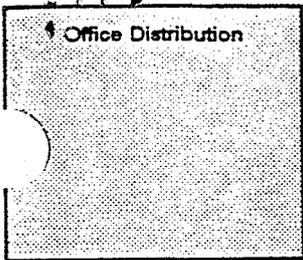
ARIZONA ELECTRIC v. ARIZONA CORPORATION COMM'N

Continued

1994) (Commission's ratemaking authority includes the "*broad power to prescribe classifications and to establish categories to consider in setting rates*" (emphasis added)); *Arizona Corp. Comm'n v. Woods*, 171 Ariz. 286, 292-94, 830 P.2d 807, 813-15 (1992) (ratemaking function includes adopting regulations that are reasonable necessary for effective ratemaking); *Ethington v. Wright*, 66 Ariz. 382, 392, 189 P.2d 209, 216 (1948) (Commission's "full and exclusive power" extends to "*making rules, regulations, and orders concerning such classifications, rates, and charges by which public service corporations are to be governed...*" (emphasis added)); *Op. Atty. Gen. No. 71-17* (Ariz. 1971) (*Appendix A*) (Commission has "broad and exclusive" power "to choose the modes by which it establishes rates").

Here, the Rules simply classify the portions of electric power service that will be subject to market-based rates in a competitive environment. That authority fits squarely within the Commission's constitutional powers. [Arizona Mining Associations's Memorandum, at 7-8]

The Commission's flexible mechanism for establishing rates, A.A.C. R14-2-1612, allows competitive rates for generated electricity to move between a floor and a ceiling, as market forces dictate, with safeguards built in to assure utilities a fair return. Provisions for automatic adjustments in rates have been upheld in the past. See *Scates v.*



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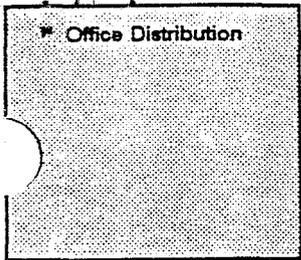
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Arizona Corp. Comm'n, 118 Ariz. 531, 578 P.2d 612 (App. 1978). This new approach to rate-making is within the broad, plenary powers bestowed upon the Commission.

3. The Administrative Procedure Act does not apply or was not violated:

The change made to A.A.C. R14-2-1611 (C) and (D) as noticed by the Commission and as subsequently adopted by it was more of a clarification of the noticed language than a substantive change requiring new proceedings.

Nor was the Attorney General's approval of the rules required. Since the rules in question resulted from the exercise of the ACC's broad rate-making power, they are not subject to certification by the Attorney General. *State ex rel. Corbin v. Arizona Corp. Comm'n*, 174 Ariz. 216, 848 P.2d 301 (App. 1992).



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FILED: _____

ARIZONA ELECTRIC POWER
COOPERATIVE, INC.

Michael M. Grant #004559

v.

THE ARIZONA CORPORATION
COMMISSION

Arizona Corporation Commission
by Lindy P. Funkhouser

Russell E. Jones #000549

Christopher Hitchcock #004523

Lawrence V. Robertson, Jr. #001709

Kenneth C. Sundlof, Jr. #004430

Louis A. Stahl #002835

Douglas C. Nelson #004787

Lex J. Smith #002615

Hon. Colin F. Campbell

The motions for summary judgment of the plaintiffs in these five (5)
consolidated cases and the cross-motion for summary judgment of the common defendant,