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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission

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JIM IRVIN
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IN THE MATTER OF THE COMPETITION IN) DOCKET NO. RE-00000C-94-0165
THE PROVISION OF ELECTRIC SERVICES)
THROUGHOUT THE STATE OF ARIZONA.) NOTICE OF FILING

Pursuant to the Procedural Order dated March 3, 1998, enclosed is Tucson Electric Power Company's Initial Post-Hearing Brief in the above-captioned matter.

RESPECTFULLY SUBMITTED this 16th day of March, 1998.

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4 **Commissioner - Chairman**
4 **RENZ D. JENNINGS**
5 **Commissioner**
6 **CARL J. KUNASEK**
6 **Commissioner**

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8 **IN THE MATTER OF THE COMPETITION IN) DOCKET NO. RE-00000C-94-0165**
8 **THE PROVISION OF ELECTRIC SERVICES)**
9 **THROUGHOUT THE STATE OF ARIZONA.) INITIAL POST-HEARING BRIEF**
9)

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13 **On Behalf of**

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15 **TUCSON ELECTRIC POWER COMPANY**

16
17 **MARCH 16, 1998**

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Exhibit A: A Sample Listing of Regulatory Compact Cases from Other Jurisdictions

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1 **EXECUTIVE SUMMARY**

2 **EXECUTIVE SUMMARY OF TEP'S INITIAL POST-HEARING BRIEF**

3 Tucson Electric Power Company ("TEP"), hereby submits this Executive Summary
4 ("Summary") of its Initial Post-Hearing Brief. This Summary shall list each of the issues posed by
5 the Commission and then concisely state TEP's position in connection therewith. A more detailed
6 explanation of TEP's positions is contained in the full body of the Initial Post-Hearing Brief which
7 will be further supplemented by TEP's Reply Brief to be filed at a later date. However, this
8 Summary is fully supported by the record of this proceeding and the legal arguments set forth in the
9 Initial Post-Hearing Brief.

10 **ISSUE NO. 1: SHOULD THE RULES BE MODIFIED REGARDING STRANDED COSTS?**
11 **IF SO, WHAT MAJOR MODIFICATIONS TO THE RULES ARE NECESSARY?**

12 The Rules should be modified to better define the procedural and substantive requirements
13 for the calculation and recovery of stranded costs. For example, the Rules should define the
14 recovery mechanisms that will be implemented; specify that different mechanisms may apply to
15 different Affected Utilities (because not all Affected Utilities are in the same financial situation) and
16 make it clear that, subject to appropriate mitigation efforts, Affected Utilities have the right to a
17 reasonable opportunity to recover all of their stranded costs. It is TEP's position that the "regulatory
18 compact" requires the Commission to allow an opportunity for full (100%) stranded cost recovery.

19 **ISSUE NO. 2: WHEN SHOULD AFFECTED UTILITIES MAKE STRANDED COST**
20 **FILINGS?**

21 TEP has proposed that if its stranded cost proposal is adopted, then Affected Utilities should
22 be required to submit stranded cost filings with the Commission within 120 days of the issuance of a
23 Decision in this generic proceeding. If the Decision requires the adoption of amendments to the
24 Rules, the filing should be within 120 days of the effective date of such amendments. If, however,
25 the Commission decides to adopt a "bottom up" approach to stranded cost calculation, given the
26 length of time necessary for appraisals and other analysis, the Company would require at least 180
27 days to file a stranded cost case.

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1 **ISSUE NO. 3: WHAT COSTS SHOULD BE INCLUDED AS PART OF STRANDED COSTS**
2 **AND HOW SHOULD THESE COSTS BE CALCULATED?**

3 **A. Includable Stranded Costs.**

4 TEP believes that the following items should be included as stranded costs:

- 5 1. Uneconomic Generation Costs;
- 6 2. Regulatory Assets (Recorded and Unrecorded); and
- 7 3. Transitional Costs

8 **B. TEP's Calculation Methodology.**

9 TEP supports the "Net Revenues Lost" methodology proposed by the Stranded Cost Working
10 Group Report ("Report") which calculates stranded costs as the net present value of future annual
11 differences in revenues under a continuation of regulation, versus the amounts likely to be realized
12 after the introduction of competition, using an appropriate discount rate. TEP proposes that auction
13 and divestiture remain an option throughout the recovery period no matter what methodology is
14 finally decided upon.

15 **C. Determination of Market Clearing Price.**

16 TEP supports the use of the Dow Jones Palo Verde Index as a market clearing price estimate.

17 **D. Implications of Financial Accounting Rules Pertinent to Stranded Cost Recovery**
18 **Plans.**

19 As soon as the Rules are modified to contain sufficient information for the Affected Utilities
20 to reasonably estimate their impact on operations, the Affected Utilities will have to cease
21 accounting for their generation operations pursuant to the Statement of Financial Accounting
22 Standards No. 71. With any method of calculation of stranded cost recovery, the amount of cash
23 flows provided is initially determined and then compared to the balances of costs earmarked to be
24 recovered. Amounts that are not recoverable through the collection of regulatory revenues are
25 written off. Therefore, recovery plans that provide for recovery of less than 100% of stranded costs
26 will likely give rise to significant write-offs.

27 The more risk that a utility is asked to assume in achieving the cash flows to recover the
28 stranded costs, the less likely that the recovery plan provides adequate assurance that the costs will
29 be recovered, and therefore, recognized on the balance sheet for financial reporting purposes. The
30 longer the recovery period, the greater the need for a true-up mechanism to allow the utility's cost

1 recovery to be re-evaluated and modified. In the alternative, a greater amount of head room within
2 the rate, or increased evidence that the costs will be recovered by the end of the stated recovery
3 period would be required to avoid write-offs.

4 **E. Income Tax Considerations for Stranded Cost Recovery Plans**

5 The amount of stranded costs to be recovered should include regulatory income tax assets
6 already due to utilities under the regulatory compact as well as the amount of any tax consequences
7 that may arise from the selected stranded cost recovery plan. Such consequences might include
8 taxability of revenues derived under a plan, or consequences from a change in qualifications under
9 Internal Revenue Service normalization rules. This is the same methodology used to calculate
10 revenue requirements in the regulated environment today.

11 **ISSUE NO. 4: SHOULD THERE BE A LIMITATION ON THE TIME FRAME OVER**
12 **WHICH STRANDED COSTS ARE CALCULATED?**

13 TEP supports the Report's recommendation that stranded costs should reflect the expected
14 remaining cost recovery periods associated with the respective assets (which includes service lives
15 implicit in current book depreciation rates, contract periods for fuel and recovery periods for
16 applicable regulatory assets and liabilities). Proper quantification of stranded costs should reflect the
17 remaining life expectancy of these underlying assets and associated costs.

18 **ISSUE NO. 5. SHOULD THERE BE A LIMITATION ON THE RECOVERY TIME FRAME**
19 **FOR STRANDED COSTS?**

20 Several factors, including (i) generation price increases, caps or reductions; (ii) the inclusion
21 of securitization as a recovery method; and (iii) the magnitude of stranded costs, will have a
22 significant impact on the recovery time frame. TEP believes that the recovery time frame should be
23 based on some reasonable balance of such considerations. Accordingly, TEP strongly supports the
24 option of securitizing a portion of stranded costs. The time frame for repayment from consumers of
25 the securitized stranded cost should be 10 - 15 years. TEP also proposes that non-securitized
26 stranded cost recovery be completed by the end of 2004. To the extent that an Affected Utility has
27 unique financial or other circumstances that justify a different stranded cost calculation and recovery
28 mechanism, the Commission should allow such mechanisms as long as they do not provide a
29 competitive advantage to the Affected Utility.

30 ...

1 **ISSUE NO. 6: HOW AND WHO SHOULD PAY FOR STRANDED COSTS AND WHO, IF**
2 **ANYONE, SHOULD BE EXCLUDED FROM PAYING FOR STRANDED COSTS?**

3 TEP proposes two recovery mechanisms to be used in tandem. First, TEP recommends
4 securitizing a portion of its stranded costs in order to accelerate the recovery. The second recovery
5 mechanism is a Competitive Transition Charge ("CTC"). TEP requests the ability to securitize up to
6 75% of its stranded costs. Securitization creates savings that are achieved by substituting the
7 utility's debt and equity capital with lower cost securitized debt capital to be repaid by all consumers
8 over time. This cost savings benefits customers. To recover the unsecuritized portion of stranded
9 costs, TEP proposes a non-bypassable CTC paid by all consumers.

10 **ISSUE NO. 7: SHOULD THERE BE A TRUE-UP MECHANISM AND, IF SO, HOW**
11 **WOULD IT OPERATE?**

12 While TEP recognizes that the Commission may desire to implement a procedure for the
13 periodic evaluation and true-up of stranded cost charges as a safeguard against over-recovery, such a
14 procedure should be designed to minimize, to the extent possible, the regulatory and administrative
15 burden associated with that procedure. To that end, the Company suggests that the structure of a
16 true-up mechanism should resemble that of the former fuel adjustment clause in which a band was
17 set based on forecasted prices and a true-up would occur annually only to the extent that revenues
18 exceed or fall short of the band ceiling or floor.

19 **ISSUE NO. 8. SHOULD THERE BE PRICE CAPS OR A RATE FREEZE IMPOSED AS**
20 **PART OF THE DEVELOPMENT OF A STRANDED COST RECOVERY PROGRAM AND**
21 **IF SO, HOW SHOULD IT BE CALCUALTED?**

22 The Company's proposal requires rates to be fixed at some level to recover stranded costs via
23 the CTC through 2004 and securitization of up to 75% of stranded costs with repayment over 10 - 15
24 years. If TEP is allowed to securitize, this approach will likely allow for full recovery of stranded
25 costs and accommodate a rate freeze. If, however, securitization is not permitted and a longer
26 recovery period is necessary to provide a reasonable opportunity for full stranded cost recovery, the
27 rate freeze would need to remain in place for a longer period of time.

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1 **ISSUE NO. 9: WHAT FACTORS SHOULD BE CONSIDERED FOR “MITIGATION” OF**
2 **STRANDED COSTS?**

3 TEP agrees that Affected Utilities should be required to exercise reasonable measures to
4 mitigate stranded costs. The challenge is in defining what would be considered “reasonable” for any
5 given company. Those actions taken by particular companies that might constitute reasonable
6 mitigation will depend on their specific circumstances and relevant market conditions. Accordingly,
7 mitigation efforts should be evaluated on a case-by-case basis.

8 **SUMMARY OF TEP’S POSITION**

9 TEP strongly believes that it has, as a matter of law, the right to a reasonable opportunity
10 to recover all of its stranded costs. This means recovery of all of its stranded costs in a reasonable
11 time frame and in a reasonable manner. TEP also believes strongly that this Commission has the
12 ethical, moral and legal duty to provide TEP a reasonable opportunity to recover all of its stranded
13 costs.

14 All along the Commission has said that the exact mechanisms and principles governing
15 stranded cost recovery would come forth from this proceeding. Accordingly, now is the time for the
16 Commission to plainly and clearly state the mechanisms by which stranded costs will be recovered,
17 the time frame within which that will occur and identify who will pay for the stranded costs. No
18 Affected Utility should be penalized, in the form of unrecoverable stranded costs (and the FAS 71
19 write-offs that may result), as a result of the Commission’s actions in transitioning from regulated
20 monopoly to a competitive marketplace.

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1 **INTRODUCTION.**

2 In Arizona, electricity is a necessity of life. Residents and businesses in this state have been
3 the recipients of safe, reliable and economical electricity for over 100 years. Only a few companies,
4 like TEP, have dedicated their resources to generate and distribute electricity throughout this State.
5 Those companies have invested billions of dollars in the infrastructure that provides electricity to
6 Arizona. In good times and bad, they have made electric service available to Arizonans.

7 The economic, legal and social structure in which electric companies operate is known as a
8 “regulated monopoly.” The Arizona Corporation Commission (“Commission”) regulates electric
9 companies by determining which companies are permitted to provide electric service, enforcing the
10 requirement that all customers receive non-discriminatory service, setting the rates that the electric
11 companies charge and approving the costs that they incur. The Commission has required that
12 electric companies recover their costs over long periods of time, thus keeping rates low for
13 customers. In return, electric utilities have been provided an opportunity to recover those costs, and
14 the opportunity to earn a rate of return established by the Commission.

15 On December 26, 1996, the Commission adopted the Electric Competition Rules (“Rules”),
16 specifically R14-2-1607 (“Rule”). The Commission indicated that the Rules would provide a basic
17 “framework” for a competitive marketplace for the retail electric industry. As part of the basic
18 framework, the Rule provided that Affected Utilities “shall recover” their stranded costs. This
19 language was adopted after months of workshops and position papers composed and submitted by
20 the Affected Utilities, consumer groups, new entrants and other interested parties. This stranded cost
21 recovery provision provides a degree of certainty with respect to how the Commission will treat
22 stranded costs.

23 An Affected Utility’s costs become stranded as a result of this Commission’s decision to
24 change the regulated monopoly environment to a competitive marketplace. Stranded costs consist
25 primarily of generation, regulatory and other assets and costs that the Commission previously
26 approved during the regulated monopoly regime, that will not be recoverable in the competitive
27 marketplace.

28 It has always been TEP’s position that the Commission should honor its past cost recovery
29 commitments. Only the Affected Utilities will have stranded costs as a result of the Commission’s
30 transition to the competitive marketplace. None of the new entrants, consumer groups or other

1 interested parties, who took part in the development of the Rules have stranded costs because they
2 have not invested in the electric infrastructure in this State like the Affected Utilities have. In its
3 opening statement, TEP brought this distinction to the Commission's attention as it stated:

4
5 You can draw with a sword a line that differentiates the parties to this
6 proceeding. On one side of the line you have the affected utilities, who,
7 with their investors, have built the electric system, which has provided
8 safe and reliable electric service to Arizona residents for more than 100
9 years. These are the only parties in this proceeding with something to
10 lose.

11 On the other side of the line are the new entrants and consumer groups
12 with everything to gain and nothing to lose. They, through their
13 testimony, want you to ignore these past 100 years of regulatory history
14 when determining the policies that will be implemented to transition from
15 a regulatory to a competitive environment. Reporter's Transcript of
16 Proceedings, (hereinafter referred to as "Tr."), at 77-78.

17 The purpose of this proceeding is to resolve outstanding issues in order to establish the
18 calculation and recovery methodologies to be applied to each Affected Utility. However, many of
19 the participants used this proceeding as yet another opportunity to advocate their parochial best
20 interests even if it required a fundamental change to the basic framework of the Rules. A
21 predominant theme by these self-interest groups was that the Rule should be diluted to only provide
22 that the Affected Utilities *may* rather than *shall* recover their stranded costs. Accordingly, much of
23 this initial brief will focus on TEP's *right* to have a reasonable opportunity to recover its stranded
24 costs.

25 **ISSUE NO. 1: SHOULD THE RULES BE MODIFIED REGARDING STRANDED COSTS?**
26 **IF SO, WHAT MAJOR MODIFICATIONS TO THE RULES ARE NECESSARY?**

27 The Rules should be modified to better define the procedural and substantive requirements
28 for the recovery of stranded costs. For example, TEP and many of the parties agree that different
29 calculations and recovery mechanisms (as opposed to one mechanism that would apply to all) should
30 be implemented because not all Affected Utilities are in the same financial situation. The Rules
should reflect this and the Commission's decision from this case should instruct that such a
modification be made.

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1 The Rules, by stating that stranded costs *shall* be recovered, provide the Affected Utilities
2 with the right to an opportunity to recover their stranded costs. As Mr. Bayless testified, to the
3 extent the Rules do not already provide this, they should be modified to make it clear that, subject to
4 appropriate mitigation efforts, Affected Utilities should have the right to a *reasonable opportunity* to
5 recover all of their stranded costs. (Ex. TEP 1, at 3.) Although some of the parties in this proceeding
6 have advocated that the Rules should be amended to permit an opportunity to recover something less
7 than 100 percent during the transition period, it is TEP's position that the "regulatory compact"
8 requires the Commission to allow an opportunity for full stranded cost recovery. The record in this
9 case fully supports TEP's position.

10 **A. The Regulatory Compact.**

11 Under the regulatory compact, the utilities were (and still are) required to plan for and
12 provide generation for all current and future customers. As Mr. Bayless testified, the investment in,
13 as well as the management and operation of, public utilities has been based on a reliance upon the
14 regulatory compact. In Arizona, electric utilities are given a Certificate of Convenience and
15 Necessity ("CC&N"), required to build facilities to serve everyone in their respective service
16 territories and are allowed the opportunity to earn a reasonable return on their investment. This
17 requirement to serve is one of the main differences between the electric industry and unregulated
18 industries. The construction of assets and facilities to serve present and future customers was
19 approved by the Commission. The recovery of these assets has been approved by the Commission.
20 If the Commission found any portion of the assets to be imprudent, it was written-off previously, and
21 hence, would not be a stranded asset today. (Ex. TEP 9, at 5.)

22 **B. Legal Precedent for The Regulatory Compact.**

23 Some parties erroneously have taken the position that there is not and never was a regulatory
24 compact. However, Mr. Fessler corrected that false notion by testifying that the regulatory compact
25 has existed in this country for over 100 years. (Ex. TEP 3, at 4.)

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1 In *Application of Trico Electric Co-operative, Inc.*, 92 Ariz. 373, 380, 377 P.2d 309 (1962),
2 the Arizona Supreme Court explained that when the Commission issues a CC&N, it is acting on
3 behalf of the State of Arizona in contracting with a public service corporation:

4
5 In the performance of its duties with respect to public service corporations
6 the Commission acts as an agency of the State. By the issuance of a
7 certificate of convenience and necessity to a public service corporation the
8 State in effect contracts that if the certificate holder will make adequate
9 investment and render competent and adequate service, he may have the
privilege of a monopoly as against any other private utility. (Emphasis
added.)

10 Thus, by the issuance of a CC&N, the State of Arizona confirms the existence of a regulatory
11 compact between the State and the public service corporation. Pursuant to that regulatory compact,
12 if the CC&N holder makes adequate investment and renders competent and adequate service, the
13 State will grant it the right to be a monopoly in a service territory, as against any other private utility.
14 *Id.*; *James P. Paul Water Co. v. Arizona Corp. Com'n* 137 Ariz. 426, 429-430, 671 P.2d 404 (1983);
15 *Corporation Com'n v. Superior Court*, 105 Ariz. 56, 59, 459 P.2d 489 (1969); *Tonto Creek*
16 *Homeowners Ass'n v. Arizona Corp. Com'n*, 177 Ariz. 49, 58, 864 P.2d 1081 (Ct. App. 1993).

17 The regulatory compact is not unique to Arizona. In fact, it is and has been the standard
18 means of operation for public utilities and governments within the United States, with historical
19 roots that pre-date Arizona's statehood.¹

20 The regulatory compact exists to "provide the public with a stable source of public services
21 and . . . assure the businesses providing these services a stable and reasonably profitable market.
22 *Fernandez v. Arizona Water Co.*, 21 Ariz. App. 107, 109, 516 P.2d 49, 51 (1973), vacated on other
23 grounds, *Arizona Corp. Com'n v. Arizona Water Co.*, 111 Ariz. 74, 523 P.2d 505 (1974). Thus, the
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26 ¹ In 1885, the *United States Supreme Court*, in *New Orleans Water-Works Co. Rivers*, 115 U.S. 674 (1885), upheld the exclusivity of
the New Orleans Water-Work's franchise with the following explanation:

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

30 (Emphasis added); see also *United States Trust Co. v. New Jersey*, 431 U.S. 1, 17 n.14 (1977); *Walla Walla City v. Walla Walla*
Water Co., 172 U.S. 1, 9 (1898); *New England Coalition on Nuclear Pollution v. Nuclear Regulatory Com'n*, 727 F.2d 1127, 1130
(D.C. Cir. 1984); and *Washington Utilities & Transportation Com'n v. Puget Sound Power & Light Co.*, 62 Pub. Util. Rep. 4th
(PUR) 557, 581 (Wash. 1984).

1 public service corporation's exclusive right, pursuant to the regulatory compact, to serve customers
2 in its service territory is a "vested property right, protected by Article 2, Section 17, of the Arizona
3 Constitution." *Application of Trico Electric Co-op, Inc.*, 92 Ariz. at 381, 377 P.2d at 315. This
4 property right arose from the regulatory compact as a result of "the legislature in granting to the
5 Commission the authority to issue certificates of convenience and necessity to public service
6 corporations." *Mountain States, Etc. v. Arizona Corp. Com'n*, 132 Ariz. 109, 114, 644 P.2d 263 (Ct.
7 App. 1982).

8 In its attempt to persuade the Commission to reduce stranded costs, some parties denied that
9 any regulatory compact exists. Hollow assertions such as Arizona courts have used regulatory
10 compact as a metaphor to describe the nature of regulated monopoly (Ex. S-1, at 2), simply will not
11 overcome the reality of the existence of the regulatory compact. As set forth herein, legal and
12 regulatory precedent in Arizona and in other jurisdictions prove the existence of regulatory compacts
13 (and, in particular, a regulatory compact between Arizona and TEP).

14 **1. Other Jurisdictions Recognize The Regulatory Compact.**

15 Regulatory commissions all around the country acknowledge that which some parties
16 refuse to admit in this matter, namely that the regulatory compact is the means by which the electric
17 industry operates. For example, in *Re Citizens Utilities Company, Kauai Electric Division*, Nos. 94-
18 0097, 94-0308, 1996 WL 497174 (HA. P.U.C. August 7, 1996), the Hawaii Public Utilities
19 Commission said:

20
21 Our decision is based in large part on the long standing regulatory
22 compact. The regulatory compact has two aspects: (1) in return for a
23 monopoly franchise, utilities accept the obligation to serve all comers; and
24 (2) in return for agreeing to commit capital necessary to allow the utilities
25 to meet the obligation, utilities are assured a fair opportunity to earn a
26 reasonable return on the capital prudently committed to the business.
27 (Emphasis added).²
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² For a sample listing of other cases in other jurisdictions, see Exhibit A.

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2. Arizona Courts Recognize The Regulatory Compact.

The Arizona Supreme Court also acknowledges that which some parties refuse to admit in this matter, namely, that the Regulatory Compact is the contractual means by which the electric industry operates in Arizona. See *In Re Trico Elec. Co-operative, Inc.*, Supra at 380.

While the some parties may, for the sake of argument in this matter, attempt to discount this language, it is clear and convincing evidence of the existence of a regulatory compact in Arizona. Moreover, the Arizona Supreme Court in *Trico* was merely restating the principle that it had set forth in *City of Tucson v. Polar Water Co.*, 76 Ariz. 404, 409, 265 P.2d 773 (1954), a case that dealt specifically with the CC&N statute:

By the issuance of its certificate of convenience and necessity, the state contracts in effect that if the certificate holder will make adequate investment and render competent and adequate service, he may have the privilege of a monopoly as against any other private utility. Certainly the state has the power by legislative act to protect the integrity of such a contract and the investments made upon the faith thereof against damage or destruction

C. The Regulatory Compact Between TEP and the State of Arizona.

TEP and its predecessors have provided electric service in Arizona since 1892. TEP currently provides retail electric service to the City of Tucson, the surrounding Pima County area and to Fort Huachuca in Cochise County (hereinafter referred to as the "TEP's service territory") pursuant to CC&Ns that it obtained from the Commission.

By agreeing to provide electric service to the public in the State of Arizona and by undertaking the capital investment to provide that service, TEP has entered into a regulatory compact with the State of Arizona, the terms of which include that:

- (a) TEP will provide reasonable and adequate service, subject to regulation by the Commission, and to make the necessary investment to provide such service;
- (b) The State confers upon TEP the exclusive right to provide electric service in TEP's service territory as evidenced by a CC&N; and

...
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1 (c) TEP will provide service to all customers within its CC&N territory who so
2 request it and can pay for it, and the State will set rates for TEP that will recover
3 TEP's costs and provide an opportunity to earn a reasonable rate of return on its
4 investment.

5 (*Bonbright v. Geary*, 210 F.44 (D.C. Ariz. 1913); *Application of Trico Electric Co-op, Inc., supra*;
6 *Scates v. Arizona Corp. Com'n*, 118 Ariz. 531, 578 P.2d 612 (1978); *Arizona Corp. Com'n v.*
7 *Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412 (1959)).

8 TEP's shareholders have invested billions of dollars to provide electric service in Arizona in
9 good faith reliance upon the regulatory compact. TEP's customers are the recipients of safe, reliable
10 and economical electric service as a result of the regulatory compact. It would be unlawful and
11 contrary to the best public interest for the Commission to not allow an opportunity for full stranded
12 cost recovery, which has been proposed by many parties to this proceeding. Indeed, any failure to
13 allow the opportunity for 100% recovery of TEP's stranded costs would be an unconstitutional
14 taking of TEP property.

15 **D. The Status of TEP's Appeal and the Regulatory Compact.**

16 Some parties have taken the tact of arguing that the Arizona Superior Court has ruled in the
17 TEP appeal of Decision No. 59943 that there is no regulatory compact.³ This is a gross distortion of
18 the Court's ruling. In fact, TEP filed a motion for summary judgment requesting that the Court
19 declare, among other things, that the Rules breach the regulatory compact entered into between TEP
20 and the State of Arizona. TEP argued that the regulatory compact could only be modified or
21 rescinded by (i) mutual agreement of TEP and the State of Arizona; (ii) by the Legislature in
22 changing the statutory provisions for CC&Ns; or (iii) by holding due process hearings.

23 The Court stated that the regulatory compact did not preclude the State from ever changing a
24 CC&N, and that the Commission could only modify TEP's CC&N after it conducted hearings
25 pursuant to A.R.S. Sec. 40-252. The Court further found that TEP had the exclusive right to provide
26 electric service within its service territory. Attached hereto as Exhibit B is a copy of Judge
27 Campbell's Minute Entry dated January 13, 1998. In fact, the Court's rulings establish that TEP
28 does have exclusive rights pursuant to its CC&N, including the exclusive right to provide service in
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³ See *Tucson Electric Power Company v. Arizona Corporation Commission*, Maricopa County Case No. 97-03748.

1 its CC&N territory and that before those rights can be disturbed, TEP must be afforded due process
2 pursuant to A.R.S. § 40-252. These rights, recognized by the Court, are the rights derived from the
3 regulatory compact. Thus, contrary to the misplaced arguments of some, the regulatory compact is
4 alive and well in Arizona.

5 **E. Other Modification to the Rule.**

6 The Commission's threshold task is to define what falls within the ambit of stranded costs
7 and how those costs are determined. In TEP's opinion, stranded costs should not be viewed simply
8 in terms of categories of costs, but rather as revenue requirements that a utility has lost the
9 opportunity to collect as a result of existing customers obtaining power from alternative sources.
10 TEP believes the following to be an appropriate definition of Stranded Costs:

11
12 An aggregation of costs (the prudence of which has already been
13 established) incurred for, or in anticipation of, the provision of service
14 under a regulatory framework, that are likely unrecoverable in a
15 competitive market for power with prices based on marginal cost. (Ex.
TEP 9, at 120).

16 This definition is similar to that appearing in R14-2-1601.8 of the Rules; however, several
17 key distinctions are noteworthy. First, the definition currently in the Rules refers to "the value of all
18 the prudent jurisdictional assets and obligations. . ." It is unclear whether such definition would
19 require a reconsideration of the prudence of past investment decisions. TEP strongly believes that
20 the consideration of stranded costs should not include ex-post prudence reviews of costs that are
21 already being recovered in the utilities' rates. The fact that recovery is already being allowed is
22 sufficient evidence of prudence as a result of prior Commission prudency determinations. Indeed,
23 TEP has already been required by the Commission to write off \$754 million, including \$428 million
24 of the cost of its Springerville and Irvington generating facilities. It is not necessary to revisit
25 prudence issues simply because some costs currently being recovered in rates might, in the future, be
26 included in a stranded cost charge. The Commission should presume that if it found an asset to be
27 prudent and allowed recovery of that asset in regulated rates, that it is eligible for stranded cost
28 recovery. To do otherwise would mean rehearing rate cases spanning the last 20 years and would
29 make stranded cost hearings extremely lengthy and contentious. There is no reason to revisit
30 prudency issues given the Commission's diligence in the past. (Ex. TEP 9, at 12.)

1 A second concern of TEP with respect to the Commission's approved definition of stranded
2 costs is that it tends to focus on the difference in values of assets and obligations under traditional
3 regulation as compared with their values after the introduction of competition. It is unclear what
4 specific assets and obligations are included and whether the definition is limited to balance sheet
5 accounts. Stranded costs are not limited to generation assets. For example, the investment in skilled
6 utility employees is a potentially stranded cost. Also utilities have considerable investments in
7 regulatory assets that exist solely based on the action of regulators and that may become strandable
8 under a competitive regime. In addition, generation-related operating expenses (*i.e.*, fuel expenses,
9 including mine reclamation costs) may be considered a potentially stranded cost. Further, some
10 stranded costs may not be presently reflected in a utility's financial statements. This is the case with
11 TEP, where certain substantial costs are not captured in its financial statements, including \$94
12 million relating to the Springerville excess capacity deferrals and \$19 million for employees' post-
13 employment benefits. (Ex. TEP 9, at 12-13.)

14 **ISSUE NO. 2: WHEN SHOULD AFFECTED UTILITIES MAKE STRANDED COST**
15 **FILINGS?**

16 The issue of stranded cost must be fully resolved prior to the introduction of competition in
17 Arizona. This hearing to resolve fundamental issues is crucial to a determination of changes to the
18 Rules that are necessary, as well as what policy guidelines need to be issued by the Commission.
19 Therefore, the Company proposes that Affected Utilities be required to submit stranded cost filings
20 with the Commission within 120 days of the issuance of a Decision in this generic proceeding. If the
21 Decision requires the adoption of amendments to the Rules, the filing should be within 120 days of
22 effectiveness of such amendments. TEP believes this is the minimum amount of time necessary to
23 put together such a filing as it will be somewhat analogous to a rate case filing. A rate case filing
24 historically takes 120-180 days to prepare. (Ex. TEP 9, at 19.) If, however, the Commission decides
25 to adopt a "bottom up" approach to stranded cost calculation, given the length of time necessary for
26 appraisals and other analysis, the Company would require at least 180 days to file a stranded cost
27 case.

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1 **ISSUE NO. 3: WHAT COSTS SHOULD BE INCLUDED AS PART OF STRANDED COSTS**
2 **AND HOW SHOULD THESE COSTS BE CALCULATED?**

3 **A. Includable Stranded Costs.**

4 TEP believes that the following items should be included in stranded costs:

5 1. Uneconomic Generation Costs

- 6 ♦ Return
- 7 ♦ Operation & Maintenance Costs
- 8 ♦ Above Market Fuel Contracts
- 9 ♦ Capital Leases
- 10 ♦ Depreciation
- 11 ♦ Property and Income Taxes
- 12 ♦ Other O&M – A&G
- 13 ♦ Cost of Removal/Decommissioning Costs
- 14 ♦ Environmental Mandates

15 2. Regulatory Assets - Recorded and Unrecorded

16 3. Transitional Costs

- 17 ♦ Labor - Retraining Costs
- 18 ♦ Costs that become stranded as a result of competition and the transition to
- 19 competition

20 **B. TEP's Calculation Methodology.**

21 TEP believes that the most appropriate method of calculating stranded costs would be to
22 calculate the difference between future revenues under traditional regulation and a competitive
23 regime. This method eliminates the need for an asset-by-asset determination, and more accurately
24 recognizes that utilities have made multiple investment decisions under the regulatory compact with
25 the expectation of revenue streams from customers to cover the costs of such investments (including
26 an opportunity to earn a reasonable rate-of-return). (Ex. TEP 9, at 13.)

27 TEP supports the "Net Revenues Lost" method proposed by the Stranded Cost Working
28 Group Report ("Report"), which calculates stranded costs as the net present value of future annual
29 differences in revenues under a continuation of regulation, versus the amounts likely to be realized
30 after the introduction of competition, using an appropriate discount rate. In general, the resulting

1 amount reflects the difference between the utility's embedded generation costs and the market's
2 marginal costs for supplying power, plus the utility's regulatory assets, both recorded and
3 unrecorded. Such a method effectively recognizes both above-market and below-market costs. (Ex.
4 TEP 9, at 13.)

5 The only feasible approach (other than the Net Lost Revenues approach) outlined in the
6 Report is auction and divestiture. TEP proposes that auction and divestiture remain an option
7 throughout the recovery period no matter what methodology is finally decided upon. If the auction
8 determined market price exceeds the unamortized book value of the generation asset, TEP will credit
9 the difference to other stranded costs (*e.g.*, regulatory assets). If unamortized book value is greater
10 than actual market value, TEP will recognize this difference as a regulatory asset to be included in
11 stranded costs and amortize this amount over the remainder of the recovery period. (Ex. TEP 9, at
12 13-14.)

13 **C. Determination of Market Clearing Price.**

14 The single most significant variable affecting the quantification of stranded costs is the
15 market clearing price for power. Any method of attempting to quantify stranded costs is necessarily
16 speculative and highly uncertain because it requires identification of all relevant resources (both
17 recorded and unrecorded) and offsets, customer demand and predictions of the market clearing price
18 for power over long periods of time. As an example, factors affecting the market clearing price for
19 power include: customer demand; market structure; generation and transmission capacity
20 availability; generation fuel mix and costs; interest rates and inflation; developments in technology
21 and new laws and regulations. However, given all these uncertainties, TEP proposes using the Dow
22 Jones Palo Verde Index ("PVI") as a market price estimate. (Ex. TEP 9, at 14.)

23 The Company believes that the PVI price is the best verifiable estimate we have of the
24 market price for electricity in Arizona. (Ex. TEP 9, at 14.) Moreover, the PVI will become more
25 robust over time as competition is extended into this State and as generation plants come out of rate
26 base.

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1 **D. Implications of Financial Accounting Principles Pertinent to Stranded Cost Recovery**
2 **Plans**

3 To date, there is insufficient specificity in the rules adopted in December 1996 to cause the
4 Arizona utilities to cease following the tenets of *Statement of Financial Accounting Standards No.*
5 *71, Accounting for the Effects of Certain Types of Regulation* ("FAS 71") for generation operations.
6 As soon as the rules contain sufficient information for utilities to reasonably estimate the impact
7 of the deregulation rules on their operations, the utilities will have to cease accounting for their
8 generation operations pursuant to FAS 71. (Ex. TEP 13, at 5.)

9 With any method of calculation of stranded cost recovery, whether it is net lost revenues,
10 replacement cost valuation, auction and divestiture, spot market valuation, or some other method
11 not yet discussed in the competition docket, the method of calculation does not impact whether the
12 method precludes or causes write-offs under FAS 71. The issue is really the cash flows expected
13 under the plan. In each case, the amount of cash flows provided by the method is initially
14 determined and then compared to the balances of costs that the cash flows are specifically earmarked
15 to recover. Recoverable amounts remain regulatory assets/liabilities of the remaining regulated
16 entity. (Ex. TEP 13, at 8.) Amounts that are not recoverable through the collection of regulatory
17 revenues are written off.

18 This cash flow analysis presumes that an entity knows the specific costs for which it is being
19 provided recovery. In the methods discussed to date in the competition docket, there is little attempt
20 to designate the stranded cost recovery dollars to specific assets. (Ex. TEP 13, at 8-9.) If the selected
21 stranded cost recovery methodology does not specifically match each cost on the balance sheet to
22 each dollar in the recovery path, the plan may not provide the specific assurances necessary for a
23 regulatory asset to be recorded under generally accepted accounting principles.

24 In the case of a regulatory asset, the *Emerging Issues Task Force Issue 97-4, Deregulation of*
25 *the Pricing of Electricity, Issues related to the Application of FAS Statements No. 71, Accounting for*
26 *the Effects of Certain Types of Regulation, and No. 101, Regulated Enterprises – Accounting for the*
27 *Discontinuation of Application of FAS Statement No. 71* (EITF 97-4) is clear in its expectation that
28 the cash flows must come from regulated revenues, rather than competitive revenues, even if it is
29 probable that such competitive revenues will be earned by the entity. The cash flows can come from
30 rates charged directly as a tariffed rate, or as a competitive transition charge, or through proceeds

1 from securitized bonds which will be paid off through regulated revenues. In addition, the cash
2 flows have to be certain enough to warrant reliance upon them as a recovery mechanism. (Ex. TEP
3 13, at 6.) Since a regulatory asset can only be recorded if a regulator provides specifically identified
4 future revenues from inclusion of the specified cost in allowable cost for ratemaking purposes, a
5 regulatory asset cannot be recorded based on achieving future cost savings, producing additional
6 future sales, identifying new sources for revenue or through some other mitigation effort which has
7 not yet occurred.

8 The more risk that a utility is asked to assume in achieving the cash flows to recover the
9 stranded costs, the less likely that the recovery plan provides adequate assurance that the costs will
10 be recovered, and therefore, recognized on the balance sheet for financial reporting purposes.
11 Recovery periods of five years or less, or about the same time period as the transition period, appear
12 to provide sufficiently timely recovery for the regulator to ensure that the utility receives its cost
13 recovery. If the plan provides for recovery over a five to ten year period, the plan *may* be considered
14 adequately timely, but considerable doubt exists as to whether recovery over a period in excess of ten
15 years would be sufficiently timely. The longer the recovery period, the greater the need for a true-up
16 mechanism to allow the utility's stranded cost recovery to be re-evaluated and modified, or a greater
17 amount of head room within the rate, or increased evidence that the costs will be recovered by the
18 end of the stated recovery period. (Ex. TEP 13, at 7.)

19 To be a meaningful true-up provision for accounting purposes, a true-up mechanism must
20 allow for upward adjustments as well as downward adjustments. The true-up mechanism would
21 allow the utilities to increase their recovery, if the original recovery path was determined to be
22 insufficient to fully recover the allowable stranded costs. (Ex. TEP 13, at 7.)

23 It is interesting to note that nearly all of the parties in this proceeding either have had no
24 opinion, or have deliberately shied away from the accounting implications of FAS 71. In some
25 instances, accounting requirements can lead to financial statement presentations that do not seem to
26 reflect the underlying economics. For example, since TEP's non-qualifying phase-in of
27 Springerville Unit 2 costs did not meet the accounting phase-in rules in *Statement of Financial*
28 *Accounting Standard No. 92, Regulated Enterprises-Accounting for Phase-In Plans* (FAS 92), the
29 deferral of the costs could not be recognized in the Company's financial statements. Even though
30 the costs are slowly being recovered, the costs had to be written off. In contrast, in the case of

1 recovery of less than 100% of stranded costs, the accounting *would follow* the economic substance of
2 the transaction. The loss of cash flows equal to the underlying cost of the stranded assets would
3 represent a real economic loss to the shareholders.

4 Using the proposed 50/50 split in stranded cost recovery as an example, the proposal would
5 seem to indicate that an entity with \$1 billion of stranded costs would be allowed to recover only
6 \$500 million of such costs. It is highly likely that the entity could endure a write-off of the 50% of
7 costs not allowed to be recovered - a \$500 million *economic* loss. The financial implications of such
8 an economic loss are far more than accounting gyrations. The entity would suffer a loss of equity, a
9 deterioration in cash flows and debt service coverage, a reduction in credit ratings, and the potential
10 loss of liquidity leading to financial insolvency. With only \$217 million of equity at December 31,
11 1997, and over \$2 billion of debt and capital lease obligations, a significant economic loss might
12 cause TEP's creditors to put TEP and its shareholders back through a financial restructuring similar
13 to the one which occurred during the early 1990's. Indeed, TEP unfortunately provides a perfect
14 example of the impact that significant economic write-offs can have on a publicly traded entity.

15 Even if an entity has sufficient equity cushion to still retain positive equity after such a write-
16 off, the significant economic loss would likely, at a minimum, cause the entity's stock price to
17 decline significantly, to reflect the on-going loss of value. Such a loss of value would make it
18 difficult, if not impossible, to raise additional equity capital from investors. These are serious
19 economic consequences which the Commission should consider in its stranded cost recovery
20 determinations.

21 **E. Income Tax Considerations for Stranded Cost Recovery Plans**

22 The amount of stranded costs to be recovered should include regulatory income tax assets. In
23 prior years when utility assets were placed in service, certain tax benefits were flowed-through to
24 customers, thus reducing income tax expense charged to customers. To the extent that not all of
25 these tax benefits have been recovered, a regulatory asset is recorded on the utility's books for the
26 amount of pretax revenues necessary to allow the utility to recoup this benefit. The utilities expect to
27 recover these amounts in accordance with the regulatory compact. (Ex. TEP 13, at 9-10.,

28 A number of witnesses in this proceeding have indicated that the affected utilities should take
29 advantage of tax write-offs to mitigate the amount of stranded costs that customers would be asked
30 to bear. This is simply an infeasible proposition. The Internal Revenue Code does not provide for

1 any deductions for the impairment of assets. A taxpayer may only take a deduction for the loss of an
2 asset if the asset is permanently abandoned or disposed of at a loss. In the case of generating
3 facilities which must continue to be operated despite an inability to recover their stranded cost
4 component, there would be no deduction available. The utility would continue to depreciate that
5 generating facility under the existing method elected for income tax purposes. (Ex. TEP 13, at 11.)

6 Further, it is unclear how the Internal Revenue Service would handle the normalization
7 requirements for a utility that is not allowed to recover 100% of its stranded costs. The Internal
8 Revenue Service has provided guidance in the case of specific assets which are no longer subject to
9 regulation, but not in the case of an overall disallowance which may apply to some or all of a
10 utility's assets. In the case of specific identification of deregulated assets, rulings provide that the
11 regulators may not reduce rate base for the deferred tax liabilities associated with the deregulated
12 assets, and that cost of service calculations may not reflect a tax deduction for depreciation on the
13 deregulated assets. (Ex. TEP 13, at 10.)

14 When the utility collects the revenues designated to recover stranded costs, the utility will be
15 required to pay income taxes on the amounts collected for both Federal and State income tax
16 purposes. As a result, in order to be made whole, the utility must receive sufficient revenues to pay
17 the taxes and still recover their investment. This is no different than the current methodology used to
18 calculate revenue requirements, which takes into consideration the taxability of the revenues to be
19 collected. (Ex. TEP 13, at 11.)

20 The Auction and Divestiture method of computing stranded costs presents an income tax
21 issue not present with other methods. Because of the use of accelerated depreciation for income tax
22 purposes, most utility assets will have a tax basis which is lower than book basis. As a result, the
23 utility will generally experience a larger gain, or reduced loss, for tax purposes than for book
24 purposes. Under the Auction and Divestiture proposal, the amount of stranded costs to be recovered
25 by the utility would be deemed to be mitigated to the extent there was income from the sale of the
26 generating assets. If this methodology is authorized, care must be taken to ensure that only the after-
27 tax income is treated as a mitigation of the stranded costs. To the extent that customers have
28 benefited in the past from the accelerated deductions which led to the lower tax basis, they should be
29 required to pay the income taxes incurred as a result of those deductions when the asset is sold. This

30 ...

1 “payment” would be made via a reduction in the amount of stranded costs treated as mitigated as a
2 result of the sale of the assets. (Ex. TEP 13, at 11.)

3 For the utilities to avoid recording write-offs under FAS 71 as a result of the stranded cost
4 recovery plan, the recovery plan must include recovery of 100% of stranded costs, including all
5 income tax regulatory assets and the income tax ramifications of the recovery mechanism chosen.
6 The recovery plan should provide for recovery of the stranded costs over a period of approximately
7 five years, and should include a true-up mechanism which allows for additional amounts of stranded
8 costs to be collected, in the event that facts and circumstances at the time of the true up indicate that
9 the recovery path initially established will be inadequate for the full amount of stranded costs to be
10 recovered. The stranded cost recovery plan proposed by Mr. Bayless is consistent with this
11 recommendation. (Ex. TEP 13, at 12.)

12 **ISSUE NO. 4: SHOULD THERE BE A LIMITATION ON THE TIME FRAME OVER**
13 **WHICH STRANDED COSTS ARE CALCULATED?**

14 TEP supports the Report's recommendation that costs should reflect the expected remaining
15 cost recovery periods associated with the respective assets which includes service lives implicit in
16 current book depreciation rates, contract periods for fuel and recovery periods for applicable
17 regulatory assets and liabilities. A significant portion of the investments implicit in stranded costs
18 are very long-term. Some of TEP's generating assets, for example, have life expectancies in excess
19 of thirty years. Historically, costs associated with these assets have been specifically incurred to
20 serve customers over an extended period of time with a reasonable expectation of a fair opportunity
21 for full recovery. Proper quantification of stranded costs should reflect the remaining life expectancy
22 of these underlying assets and associated costs. (Ex. TEP 9, at 15.)

23 **ISSUE NO. 5. SHOULD THERE BE A LIMITATION ON THE RECOVERY TIME FRAME**
24 **FOR STRANDED COSTS?**

25 The interest of the utilities, their shareholders and consumers all need to be balanced in
26 determining the time frame for stranded cost recovery. All parties will prefer as short a recovery
27 time frame as possible. However, several factors, including (i) generation price increases, caps or
28 reductions; (ii) the inclusion of securitization as a recovery method; and (iii) the magnitude of
29 stranded costs, also have a significant impact on the recovery time frame. TEP believes that the
30 recovery time frame should be based on some reasonable balance of such considerations.

1 Accordingly, TEP strongly supports the option of securitizing a portion of stranded costs. The time
2 frame for repayment from all consumers (including special contracts, interruptible customers and
3 cogeneration) of the securitized portion stranded cost should be 10 - 15 years. TEP also proposes
4 that non-securitized stranded cost recovery be completed by the end of 2004. (Ex. TEP 9, at 15-16.)
5 To the extent that an Affected Utility has unique financial or other circumstances that justify a
6 different stranded cost calculation and recovery mechanism, the Commission should allow such
7 mechanisms as long as they do not provide a competitive advantage to the Affected Utility.

8 **ISSUE NO. 6: HOW AND WHO SHOULD PAY FOR STRANDED COSTS AND WHO, IF**
9 **ANYONE, SHOULD BE EXCLUDED FROM PAYING FOR STRANDED COSTS?**

10 TEP proposes two recovery mechanisms to be used in tandem. First, TEP recommends
11 securitizing a portion of its stranded costs in order to accelerate the recovery. The second recovery
12 mechanism is a CTC. (Ex. TEP 9, at 16.)

13 TEP requests the ability to securitize up to 75% of its stranded costs. Securitization creates
14 savings that are achieved by substituting the utility's debt and equity capital with lower cost
15 securitized debt capital to be repaid by all consumers over time. This cost savings benefits
16 customers. To recover the unsecuritized portion of stranded costs, TEP proposes a non-bypassable
17 CTC paid by all consumers. TEP will bill customers at rates which include the CTC. The CTC will
18 be computed as the difference between the generation-related portion of TEP's rates and the PVI
19 price. Customers who choose a different Energy Service Provider ("ESP") will be credited the PVI
20 price and be responsible for paying the kWh charge they agreed to pay their ESP. If, however,
21 securitization is not allowed, TEP will not be able to recover its stranded costs over as short a time
22 period and will therefore seek a recovery period as long as needed to recover TEP's stranded costs
23 using the CTC recovery mechanism. (Ex. TEP 9, at 16.)

24 **ISSUE NO. 7: SHOULD THERE BE A TRUE-UP MECHANISM AND, IF SO, HOW**
25 **WOULD IT OPERATE?**

26 While TEP recognizes that the Commission may desire to implement a procedure for the
27 periodic evaluation and true-up of stranded cost charges as a safeguard against over-recovery, such a
28 procedure should be designed to minimize, to the extent possible, the regulatory and administrative
29 burden associated with that procedure. To that end, the Company suggests that the structure of a
30 true-up mechanism should resemble that of the former fuel adjustment clause in which a band was

1 set based on forecasted prices and a true-up would occur annually only to the extent that revenues
2 exceed or fall short of the band ceiling or floor. For example, if the market price forecast error
3 exceeds a predetermined threshold limit, an adjustment to the recovery mechanism would be
4 implemented. (Ex. TEP 9, at 17.)

5 **ISSUE NO. 8. SHOULD THERE BE PRICE CAPS OR A RATE FREEZE IMPOSED AS**
6 **PART OF THE DEVELOPMENT OF A STRANDED COST RECOVERY PROGRAM AND**
7 **IF SO, HOW SHOULD IT BE CALCUALTED?**

8 The Company's proposal requires rates to be fixed at some level to recover stranded costs via
9 the CTC through 2004 and securitization of up to 75% of stranded costs with repayment over 10 - 15
10 years. If TEP is allowed to securitize, this approach will likely allow for full recovery of stranded
11 costs and accommodate a rate freeze. (Ex. TEP 9, at 17.) If, however, securitization is not permitted
12 and a longer recovery period is necessary to provide a reasonable opportunity for full stranded cost
13 recovery, the rate freeze would need to remain in place for a longer period of time.

14 **ISSUE NO. 9: WHAT FACTORS SHOULD BE CONSIDERED FOR "MITIGATION" OF**
15 **STRANDED COSTS?**

16 Under the Rules, Affected Utilities are expected to take steps to minimize stranded cost
17 exposure. TEP agrees that utilities should be required to exercise reasonable measures to mitigate
18 stranded costs. The challenge is in defining what would be considered "reasonable" for any given
19 company. Those actions taken by particular companies that might constitute reasonable mitigation
20 will depend on their specific circumstances and relevant market conditions. Accordingly, mitigation
21 efforts should be evaluated on a case-by-case basis. (Ex. TEP 9, at 18.)

22 The Rules suggest the expansion of wholesale or retail markets as a way to mitigate stranded
23 costs. Such activity is not likely to significantly mitigate stranded costs because the Company
24 proposes that market clearing prices be used to determine stranded costs. As a result, the value of
25 market prices are fully reflected in the computation of stranded costs. (Ex. TEP 9, at 18.)

26 The Rules also identify the offering of a wider scope of services for profit as another means
27 to mitigate stranded costs. It is unclear whether this suggested action is intended to include only
28 jurisdictional-related activities or is broader in its intended range of contemplated business pursuits,
29 covering any business activity the utility and/or its affiliates may choose to engage in. TEP believes
30 that profits from activities that are unrelated to the provision of electricity in Arizona (which were

1 funded with shareholder dollars) that do not require use of the assets that were acquired to serve
2 electric customers in Arizona, and that are at risk to the utility's shareholders (but not customers),
3 should not be considered as a source of funds to offset stranded costs. (Ex. TEP 9, at 18.)

4 Other approaches to mitigating stranded costs may include asset sales, renegotiating
5 uneconomic contracts (as TEP has already done in recent years by renegotiating certain fuel supply
6 agreements), pursuing economic development projects and continually attempting to lower marginal
7 costs (as TEP has done through corporate re-engineering, its voluntary severance plan and similar
8 cost-reduction efforts). It should also be noted that mitigation efforts themselves may lead to
9 additional costs that need to be recovered from customers. What constitutes appropriate mitigation
10 for any utility should include consideration of all relevant facts and circumstances. (Ex. TEP 9, at
11 18-19.)

12 CONCLUSION

13 It is not necessary for Arizona to go blindly into the transition from regulation to
14 competition. Other states have gone through this process and we can learn from those experiences,
15 good as well as bad. Towards that end, TEP is the only party to have presented the testimony of two
16 regulators that have gone through what the Commission is going through today. Mr. Daniel Fessler,
17 the former President of the California Public Utility Commission when asked whether the positions
18 taken by the various stakeholders in this proceeding exhibit a degree of consensus necessary to
19 advance the introduction of competition, stated:

20
21 Unfortunately, they do not. Indeed, the range of opinion on such vital
22 issues as whether there is a regulatory compact which must be respected
23 and, if so, the consequences of such a compact is wider in scope and more
24 vociferous in tone than anything I can remember in the nearly four years in
25 which these issues were debated in California. I find this particularly
26 troubling because we are now less than 11 months from the point at which
27 the Commission Rules call for the introduction of competition. Unless
28 these hearings are able to move the various stakeholders to a constructive
29 resolution of these issues, I fear for the timely introduction of competition
30 in Arizona. (Ex. TEP 3, at 1.)

28 ...

29 ...

30 ...

1 Mr. Kenneth Gordon, former Chairman of the Massachusetts Pubic Service Commission
2 stated:

3
4 The Massachusetts Commission started the process of investigating the
5 possibility of introducing competition in the generation market in early
6 1995 while I was Chairman of that Commission. We issued our first order
7 in August of that year, essentially laying out the policy principles that
8 would guide our effort. As I noted in my direct testimony, one of those
9 policy principles was to honor existing commitments and allow an
10 opportunity for full stranded cost recovery. (Ex. TEP 7, at 20.)

11 Mr. Gordon went on to say that before final legislation was passed, three years were needed
12 to resolve implementation issues among most of the large investor-owned utilities. This is also
13 consistent with the California experience. Hence, Arizona is attempting to do in the next nine
14 months what took California and Massachusetts three years to accomplish and they are still not there.
15 But the only way they were able to accomplish what they did, was to recognize the existence of the
16 regulatory compact and honor their past commitments to the utilities and shareholders before moving
17 to competition. By doing this, it allowed the various stakeholders to focus on operational, consumer
18 and other implementation issues necessary before competition could be introduced.

19 On the eve of the introduction of retail electric competition in Arizona, TEP urges the
20 Commission not to change the basic framework that it adopted 15 months ago. The Commission
21 should recognize and honor its past commitments and move on. Otherwise, the legal and financial
22 consequences (such as the potential for immediate FAS 71 write-offs) that have been discussed
23 throughout this proceeding by the Affected Utilities, and ignored by most other parties, will become
24 a reality long before retail competition.

25 TEP's position regarding its right to a reasonable *opportunity* for 100% stranded cost
26 recovery can be capsulized in the following passage from an answer given by Mr. Fessler to a
27 question posed by Commissioner Jennings:

28 That was, in my judgment, never a 100 percent guaranteed result, but if the
29 Commission moves away from its historic relationship with its investor-
30 owned utilities, and jurisdictional entities, that it is obligated, as a matter
of decency, as a matter of expediency, and yes, in my judgment, ultimately
as a matter of law, to provide the utilities with a comparable opportunity.
(Tr. 459.)

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Again, no Affected Utility should be penalized, in the form of unrecoverable stranded costs (and the FAS 71 write-offs that may result), as a result of the Commission's actions in transitioning from regulated monopoly to a competitive marketplace.

**A SAMPLE LISTING OF REGULATORY COMPACT CASES FROM OTHER
JURISDICTIONS**

- 1) *In Re South Carolina Electric and Gas Company*, 167 P.U.R. 4th 154, 159, 161 (1996):

Traditionally, utilities have operated under a set of interrelated principles collectively referred to as the 'regulatory compact.'...SCE&G's customers have received substantial benefits from this regulatory compact. They have been guaranteed electric service on demand. The availability of electric service and its reliability of supply have been assured. In reliance on this compact, SCE&G has raised billions of dollars in capital markets to invest in highly efficient plants. Rates have been moderated by spreading recovery of this multi-billion dollar investment over much longer periods of time that would be reasonable absent regulatory protection. All of this has been based on the guarantee that, through regulation, SCE&G would have a monopoly franchise and the opportunity to recover its reasonable costs incurred in providing service;

- 2) *In Re Electric Utility Industry Restructuring*, No. 95-462, 1996 WL 467779 (ME. P.U.C. July 19, 1996):

The obligation to serve in return for exclusive service territories is commonly called the regulatory compact. Industry restructuring would, in effect, modify this compact");

- 3) *Application of Pacific Gas and Electric Company*, No. 96-09-045, 1996 WL 532356 (September 4, 1996):

The notion that customers are entitled to reliable service is an essential aspect of the regulatory compact;

- 4) *Re Ratemaking Treatment of Capital Gains, et. seq.*, 104 P.U.R. 4th 157, 160 (1989):

We need not specify the entire regulatory compact in any detail to conclude that it is fair and reasonable to preserve the relative positions of utility shareholders and ratepayers who remain under our jurisdiction;

- 5) *In Re Northern Indiana Public Service Company*, 166 P.U.R. 4th 213 (1995):

At the heart of the regulatory framework is the so-called 'regulatory compact.'

[t]he regulation of utilities arises out of a 'bargain' struck between the utilities and the state. As a quid pro quo for being granted a monopoly in a geographical area for the provision of a

1 particular food or service, the utility is subject to regulation by
2 the state to ensure that it is prudently investing its revenues in
3 order to provide the best and most efficient service possible to
the consumer;

- 4 6) *In Re Brandenburg Telephone Company, Inc.*, No. 92-563, 1994 WL 1448731 (Ky. P.S.C.
5 March 25, 1994):

6 Brandenburg enjoys the benefits of a monopoly. In return for this benefit,
7 it is obligated to provide services at the lowest rates consistent with a fair
8 return. That is the nature of the regulatory compact in its traditional form.;

- 9 7) *In Re Commonwealth Edison Company*, 117 P.U.R. 4th 401 (1988):

10 The long run goal is to provide the amount of electricity needed as cheaply
11 as possible. The traditional regulatory compact does this. The regulatory
12 compact or bargain is a sensible arrangement by which shareholders are
13 told how they are going to be treated and lend money on that basis and the
14 utility is told by its commission on behalf of ratepayer how it should
conduct itself within specified rules of efficiency and prudence in order to
be paid a compensatory rate of return;

- 15 8) *In Wash. Util. and Trans. Com'n v. Puget Sound Power & Light Co.*, 62 P.U.R. 4th 557, 581
16 (1984):

17 The social and economic compact of utility regulation begins with the
18 premise that a regulated utility has an obligation to serve the public. [A]
19 utility possesses an unending obligation to provide service to anyone
20 within the service territory of that utility who demands service in
21 accordance with approved tariffs. However, in order for the social duty to
22 serve to be viable, the compact must also provide for a utility to recover
expense it prudently undertakes to meet the obligation;

- 23 9) *In Re Boston Edison Company*, 46 P.U.R. 4th 431, 455 (1982):

24 As we indicated earlier, a basic part of the regulatory compact is the need
25 to provide compensation to suppliers of capital. Public utility law
26 recognizes this basic part of the bargain by incorporating a special
27 obligation of financial support to its balancing calculus.
28
29
30

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SUPERIOR COURT OF ARIZONA
MARICOPA COUNTY

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CLERK OF THE COURT

January 13, 1998

HON. COLIN F. CAMPBELL

E. Schneider
Deputy

N° CV 97-03748 (Consolidated)

JAN 14 1998

FILED: _____

TUCSON ELECTRIC POWER CO.

Raymond S. Heyman

v.

Bradley S. Carroll (Tucson)

THE ARIZONA CORPORATION
COMMISSION, et al.

Beth Ann Burns

Janet F. Wagner

Lawrence V. Robertson, Jr.

Glenn J. Carter

Jane D. Alfano

Douglas C. Nelson

Louis A. Stahl

Lex J. Smith

Michael M. Grant

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

The Court took this case under advisement after supplemental briefing requested by the Court.

At the outset, if it was not clear by the Court's prior order, the Court rejects the argument that TEP does not have an exclusive right under its Certificate of Convenience and Necessity to service its geographic area with its electrical system. TEP's CC&N consists, among other documents, of an opinion and order entered by the Arizona Corporation Commission and docketed August 10, 1968. The opinion and order addresses rival claims made

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TUCSON ELECTRIC V. ARIZONA CORP. COMMISSION

Continued

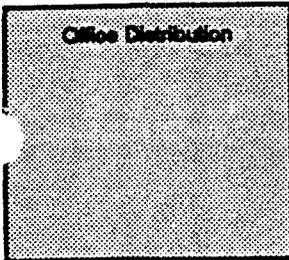
by Trico and TEP. The opinion states:

Trico's certificate did not give Trico the right and power to operate as a public utility to serve the public generally, nor did it give any basis from which Trico can, as a matter of right, without further action of the Commission, elevate its status to that of a public utility serving the public generally in the rural areas of Pima, Pinal and Santa Cruz Counties to the exclusion of other public service corporations which are true public utilities under the law of Arizona.

IT IS FURTHER ORDERED that a Certificate of Public Convenience and Necessity be, and the same is, hereby issued to The Tucson Gas, Electric Light and Power Company to serve electricity as a public utility and to construct, operate and maintain an electric public utility system in all of the areas of Tucson and Pima County, Arizona, described on said Exhibit A.

Arizona Corporation Commission's Statement of Facts, exhibit M, filed July 25, 1997. The opinion and order, especially read in historical context, plainly grants TEP status as a "true public utility" with the right to serve the public to the exclusion of other public service corporations within its geographic area. Indeed, Decision 59943, which promulgated the competition rules, states as much. Noting that TEP was not receptive to the proposed rules, the Commission stated this "is certainly understandable since, under the proposed rules, their status as monopoly providers of electric service will change."

To be sure, the Court agrees with the Arizona Corporation Commission that it does not have to grant a regulated monopoly for a service area under the statutes; but the Court cannot rewrite history. The Corporation Commission has granted through its CC&N exclusive rights to TEP. Indeed, for most this century the presumption has been that regulated monopoly was preferable to free-wheeling competition. See Corporation Commission v. Peoples



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TUCSON ELECTRIC V. ARIZONA CORP. COMMISSION

Continued

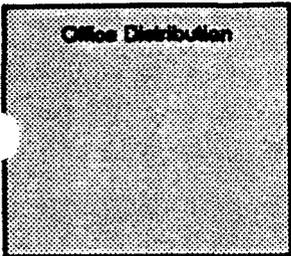
F. Line, Inc., 41 Ariz. 158 (1932).

In its prior order, the Court held that TEP does not have a right to its regulated monopoly in perpetuity; rather, TEP's CC&N can be amended, altered or revised through a section 40-252 hearing to take away its exclusive right to generate electricity for its area. The issue then presented is whether a section 40-252 hearing has been held and, if not, when must the section 40-252 hearing be held? TEP argues that all of the Corporation Commission's rule making proceedings with a view towards deregulation of electrical generation is invalid until a section 40-252 hearing on its CC&N is held.

The Court concludes that the general rule making procedures preceding and accompanying Decision 59943 is not a section 40-252 hearing. Indeed, the rules set forth in Decision 59943 make no mention of a section 40-252 hearing before granting competitive rights to sell electricity in TEP's service area. Further, the rules set dates to turn over percentages of markets to competition before a section 40-252 hearing is held.

At this juncture, however, the Court holds that the Commission's deregulation rules should not be set aside because a section 40-252 hearing has not been held. TEP continues to operate as a regulated monopoly under its CC&N. The Commission has not yet granted any CC&N that would conflict with TEP's regulated monopoly. As long as a fair section 40-252 hearing is held prior to granting any competitive CC&N's for electrical generation for the area, the Court does not find any violation in proceeding with general rule-making for deregulation. Indeed, without rules to govern how competition would work, such as what stranded costs or distribution costs would be, the Commission does not have any specific factual basis to assess the public interest regarding pricing at a future section 40-252 hearing as to whether TEP's regulated monopoly should be maintained or altered.

Accordingly,



SUPERIOR COURT OF ARIZONA
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TUCSON ELECTRIC V. ARIZONA CORP. COMMISSION

Continued

IT IS ORDERED:

1. Denying TEP's request that the deregulation rules be set aside in their entirety until a section 40-252 hearing is held.