BEFORE THE ARIZONA CORPORATION COMMISSION

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

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

DOCKET NO. RE-00000C-94-0165
(formerly U-0000-94-165)

INITIAL BRIEF OF ARIZONA ELECTRIC POWER COOPERATIVE, INC.

Pursuant to the Procedural Order dated March 3, 1998, Arizona Electric Power Cooperative, Inc. ("AEPCO") submits this Initial Brief in relation to the above entitled matter. As requested, this Brief will set forth a summary of AEPCO's responses to the eleven questions contained in the Procedural Orders dated December 1 and December 11, 1997.

INTRODUCTION

After more than thirty witnesses, 4,000 pages of transcripts and three weeks of hearing, one thing has been established beyond any doubt: Cooperatives are different. In describing their lack of shareholder/customer conflict, former California Public Utilities Commission Chairman Daniel Fessler phrased it lyrically:

> [N]ot on you, not on me, stick it to the fellow behind the tree. [In cooperatives' case] there wasn't any fellow behind the tree...[1]

As the Commission is aware, Cooperatives are nonprofit, customer owned, customer run organizations. They provide service to areas which, regardless of ones' feelings about the benefits of

[1] Hearing Transcript (hereinafter HR TR), p. 534, ll. 1-4.

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competition, are likely to be most at risk in the transition to a competitive marketplace. Former NARUC President Kenneth Gordon agreed, at a minimum, that rural areas would see delayed competition benefits:

> Q. Would it be prudent, since, obviously, we don't know what's going to happen, that perhaps that would emphasize the need to at least make sure that the institutions, organizations that have been serving in this case, rural Arizona, are kept financially viable, if nothing else than to hedge that bet to see how the competitive marketplace might play out?
>
> A. Yes. I think not just for that reason. It just seems to be me reasonable, if they are performing their utility service properly, it seems reasonable to treat them equitably and maintain whatever the -- have customers paying whatever the appropriate costs are to keep the businesses on a good going forward basis with or without competition.[2]

Ms. Pruitt, on behalf of the Arizona Community Action Association, agreed that a different set of answers was appropriate for cooperatives than investor owned utilities in relation to stranded costs.[3] Similarly, Dr. Coyle, on behalf of the City of Tucson, agreed that stranded costs concerns he expressed generally in his testimony were not appropriate in relation to customer owned cooperatives.[4]

Dr. Cooper, on behalf of the Arizona Consumers Council, stated that cooperatives are in many respects different than

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[2] HR TR, p. 744, l. 11 to p. 744, l. 1. (emphasis supplied).

[3] HR TR, pp. 266 to 267.

[4] HR TR, p. 1095, l. 20 to p. 1096, l. 24.

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investor owned utilities and appropriately should be treated differently in relation to stranded costs. A copy of Dr. Cooper's testimony in this regard is attached hereto as Exhibit A.

AEPCO and its member distribution cooperatives have doubts about this great competition experiment and the benefits it may or may not bring to rural Arizona. They serve markets that even a highly regulated industry left unserved for much of this century. As Mr. Minson, AEPCO's Assistant General Manager - Finance, described on cross-examination, competition initiatives in other industries have often left rural Arizona disadvantaged. Four branch bank offices used to exist in Benson. Upon deregulation, there are now two. In airlines, even a major city like Tucson is disadvantaged. In order to obtain cheaper fares, one must first fly to Phoenix.[5] However, Mr. Minson had an answer for safeguards to protect these rural customers in a competitive environment:

> I think if you maintain, if you allow AEPCO and its distribution cooperatives to maintain their financial viability, I am speaking here specifically of stranded costs, we can do the job. But we have got to be given the opportunity.[6]

AEPCO would request that the Commission keep these differences and this solution in mind in reviewing its responses to the specific questions concerning stranded costs.

1. Should the Electric Competition Rules be modified regarding stranded costs, if so, how.

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[5] HR TR, p. 3050, l. 14 to p. 3051, l. 14.

[6] HR TR, p. 3051, ll. 17 to 21.

AEPCO has suggested three amendments to the Rules regarding stranded costs. They were discussed at pages 9 to 10 of Mr. Minson's Direct Testimony (AEPCO Exhibit 3).

First, in relation to mitigation duties and allowable profits and expenses, the following new language should be substituted for the current R14-2-1607.A:

> A. The affected utilities shall undertake reasonable, cost effective measures to mitigate or offset Stranded Cost. However, neither revenues from nor expenses incurred in non-jurisdictional activities shall be considered in mitigation or calculation of Stranded Cost.

Almost all parties presenting testimony were in agreement that nonjurisdictional activities should not be credited or debited against stranded costs.

Second, most parties were also in agreement that stranded cost recovery should be assessed against all customers.[7] In that regard, AEPCO has suggested that all text after "from customers" be deleted in R14-2-1607.H and R14-2-1607.J be deleted in its entirety.

Finally, to avoid needless, time consuming debate over already settled issues, AEPCO has suggested a prudence exclusion be added to R14-2-1607.I:

> The prudence of an Affected Utilities' investment prior to the effective date of this

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[7] See, for example, the testimony of Albert Sterman on behalf of the Arizona Consumers Council, HR TR, p. 2366, l. 24 to p. 2367, l. 2. Also, the testimony of Jack Davis on behalf of Arizona Public Service (Recovery should be from all customers with no exclusion for self-generators or interruptible power consumers.) HR TR, p. 3690, l. 13 to p. 3691, l. 19.

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> article which the Commission had a reasonable opportunity to evaluate shall not be at issue in the stranded cost determination.[8]

This recommendation is consistent with the high burden of proof required to challenge prior utility investments as currently reflected in the Commission's Rules at R14-2-103.A.3.l.

2. When should "Affected Utilities" be required to make a "stranded cost" filing pursuant to A.A.C. R-14-2-1607?

All parties agreed that a utility specific stranded cost filing should be made promptly. However, the calculation of stranded costs is not an easy, nor quick exercise.

For AEPCO's part, it can commit to make a stranded cost filing based on the net revenues lost approach no later than ninety days following the issuance of the Order in this proceeding. This would allow Staff and the Commission approximately six months to evaluate this filing prior to the currently scheduled date for competition of January 1, 1999.

On behalf of its member distribution cooperatives, AEPCO also recommends that the Commission not impose any mandatory cutoff date for seeking stranded costs. Because the Rules authorize competition in certain distribution related services, there may be distribution related stranded costs. However, their extent will not be known until the transition period is underway.[9] Commission

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[8] Based upon a cross-examination question asked of Mr. Minson, AEPCO has slightly revised this recommendation to allow Commission review of investments not previously considered.

[9] See, for example, Breen testimony, HR TR, pp. 154-155; Propper testimony, HR TR, p. 2093, l. 3 to p. 2095, l. 5; and Minson testimony, p. 3018.

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procedures should be sufficiently flexible to allow timely requests for stranded costs as they arise.

3. What costs should be included as part of "stranded costs" and how should those costs be calculated? (By subsequent Procedural Order, this question also includes calculation methodology, assumptions made on market clearing price and the implications of FASB No. 71).

AEPCO recommends that it use a "net revenues lost" approach in calculating its stranded costs.[10] As Mr. Edwards of CFC stated:

> The lost revenues method should be the methodology used to determine stranded costs. The lost revenues approach is particularly well suited for AEPCO since it seeks only to cover its costs and its mortgage coverage requirements.

Obviously, this question generated the most controversy and debate during the hearing. However, as previously discussed, most witnesses agreed that this debate did not apply to customer owned, customer run cooperatives like AEPCO.

For example, Staff witness Dr. Kenneth Rose agreed that AEPCO's "net revenues lost" methodology designed to cover reasonable operating costs and meet mortgage criteria would be consistent with his "transition revenue" recommendation.[11] Similarly, Mr. Higgins, on behalf of Arizonans for Electric Choice, agreed that AEPCO's approach to stranded cost recovery would be appropriate for cooperatives:

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[10] AEPCO Exhibit 1, pp. 10 -11; AEPCO Exhibit 2, p. 7; AEPCO Exhibit 3, pp. 3 - 5; and AEPCO Exhibit 4, pp. 6 - 7.

[11] HR TR, pp. 3308 to 3310. Accord: Testimony of Mr. Edwards, AEPCO Exhibit 4, p. 6, l. 32 to p. 7, l. 12.

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Q. To the extent, Mr. Higgins, that a cooperative were simply to become before this Commission seeking on a prospective basis in relation to stranded costs what it has always sought historically, that being simply to cover its reasonable operating costs and to safely meet its mortgage criteria, avoid default, would you have any objections to that approach for a cooperative in relation to stranded costs?

A. I believe that avoiding default is one of the factors that the Commission has already identified in the Rule that -- the Factor No. 3. And I believe that that is an appropriate consideration in designing the stranded costs recovery.

Q. And do you understand that the main mortgage criteria are, in fact, the principle criteria which drive a cooperative's rate and, for that matter, stranded cost needs?

A. I believe that that is plausible.[12]

In summary, the hearing produced generally uniform agreement that a net revenues lost approach as proposed by AEPCO would be appropriate and reasonable for cooperatives.

As to the remaining matters posed by this question, they should be appropriately left to utility specific stranded cost proceedings. AEPCO's primary categories of stranded costs will consist of regulatory assets, generation related costs and possibly long-term purchased power obligations. More specificity will be provided in the AEPCO specific stranded cost filing. As to market clearing price, that also may be left to the next stage of this endeavor. In general, however, AEPCO recommends a price which will

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[12] HR TR, p. 4118, l. 19 to p. 4119, l. 14.

reflect longer term considerations so as to minimize stranded costs.[13]

Finally, as to FASB No. 71 issues, each accounting witness was consistent that there may be serious consequences associated with a Commission decision indicating that an Affected Utility may not be allowed to recover unmitigated stranded costs. Because of the reasonably strong assurance of stranded cost recovery contained in the current Rules, Affected Utilities like AEPCO have been able to avoid unnecessary write-offs or write-downs of assets which, in AEPCO's case, would worsen its negative equity situation and drive its costs higher.[14]

AEPCO would strongly urge the Commission to avoid any statements in this Order or Rules' amendments which would produce these adverse results. In particular, the Commission should not accept Staff's recommendation that R14-2-1607 be modified to reflect permissive recovery of stranded costs. As Mr. Minson testified:

> Staff's sudden and inexplicable reversal of position, both as to the rules it recommended the Commission adopt, as well as positions it articulated in the working groups' final report will complicate, not accelerate, this Commission's stated goal of moving toward competition in the electric industry. Also, if the Commission were to modify its rules as suggested by Staff, the accounting and financial consequences could be significant. Although I am not an accountant, I work with AEPCO's auditors on its financial statements. I can confidently predict that a statement by

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[13] <u>See</u>, for example, Mr. Bullis and Mr. Rudibaugh's questions of Mr. Minson at HR TR, pp. 3053 to 3055.

[14] AEPCO Exhibit 4, pp. 2 - 5.

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> this Commission such as the one recommended by Staff that unmitigated stranded costs can be disallowed will have serious and immediate FASB 71 and FASB 121 implications.[15]

4. Should there be a limitation on the time frame over which "stranded costs" are calculated?

AEPCO does not believe there should be a Rules' limitation on the time frame over which stranded costs are calculated. This issue should be left to utility specific stranded cost proceedings.

5. Should there be a limitation on the recovery time frame for "stranded costs"?

AEPCO also believes that there should be no generic limitation on the recovery time frame for stranded costs stated in the Commission Rules. Instead, this issue should be left to utility specific proceedings.

6. How and who should pay for "stranded costs" and who, if anyone, should be excluded for stranded costs?

Most of the issues concerning who should pay and who should be excluded have already been addressed in response to Question 1 on suggested amendments. As to "how", in general, AEPCO proposes a "wires" charge that would be passed through its distribution cooperative member owners to their member owners. The wires charge would be coordinated with the standard offer rate to assure that there is no double recovery of stranded costs.[16]

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[15] AEPCO Exhibit 4, p. 5, ll. 4-16. See also the testimony of Ben McKnight, HR TR, pp. 2400 to 2403.

[16] Mr. Minson's testimony at HR TR, p. 3020. Ms. Pruitt, on behalf of ACAA, indicated that if a stranded cost allowance was made for the standard offer customer to assure that customer did not pay twice, it would alleviate her concerns about "double dipping". HR TR, p. 268, l. 15 to p. 269, l. 18.

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7. Should there be a true up mechanism and, if so, how would it operate?

AEPCO believes that a true up mechanism would be appropriate to make sure that its member owners neither under nor over pay stranded costs. Although the precise details of a true up mechanism should be left to AEPCO's specific stranded cost proceeding, AEPCO envisions a clause mechanism similar to its PPFAC with benchmarks and filing requirements established during that proceeding.[17]

8. Should there be price caps or a rate freeze imposed as part of the development of a stranded cost recovery program and if so, how should it be calculated?

As Mr. Minson explained, AEPCO opposes rate caps or price freezes for a variety of reasons:

> [T]o the extent such a cap or freeze is intended to immunize consumers from the consequences of the market, this would be bad policy. Shifting to competition and market based rates entails risks and rewards. Arbitrary regulatory interference to shield customers from the consequences of choice is irrational and does not allow the market to work as it should. Finally, like most price or cost control schemes, in my opinion rate caps or price freezes would be administratively difficult if not impossible to police and undoubtedly would create unintended consequences and gaming possibilities.[18]

Several other witnesses agreed. For example, Dr. Michael Block of the Goldwater Institute referred to caps and freezes as positively

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[17] AEPCO is intrigued by the variant of the net revenues lost approach proposed by Arizona Public Service which might alleviate the need for a true up mechanism. It plans to study further this proposal and if feasible may incorporate it in its specific stranded cost filing.

[18] AEPCO Exhibit 4, p. 8, ll. 6 - 15.

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a bad thing.[19] Dr. John Landon, on behalf of Arizona Public Service, testified that rate freezes and price caps would be inconsistent with the competitive market.[20] On behalf of Staff, Dr. Rose agreed that any kind of price cap would have to make allowance for cost changes in the transmission and distribution rate.[21]

The Commission also does not have the jurisdiction to impose either a price cap or rate freeze. Arizona law is clear that public service corporations are entitled to a reasonable return on the fair value of their property determined at time of inquiry. See, for example, Simms v. Round Valley Light and Power Co., 80 Ariz. 145, 294 P.2d 378 (1956); Scates v. Ariz. Corp. Comm'n, 118 Ariz. 531, 578 P.2d 612 (App. 1978); and Consol. Water v. Ariz. Corp. Comm'n, 178 Ariz. 478, 875 P.2d 137 (1993). Obviously, any broad pronouncement by this Commission that a particular rate level is mandatory on a going forward basis would violate this Commission's constitutional duties and would, in fact, be confiscatory.

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

This question has been dealt with in AEPCO's response to Question 1. AEPCO believes that the Rules should be amended to make clear that neither profits nor losses from nonjurisdictional activities should be considered in mitigation of stranded costs.

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[19] HR TR, p. 3539, ll. 3 - 15.

[20] HR TR, p. 2860, l. 18 to p. 2862, l. 2.

[21] HR TR, pp. 3320 - 3321.

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As to the merits, AEPCO has already taken several steps to mitigate its stranded costs although it views those efforts not as "mitigation" but rather as part of its ongoing obligation to provide reliable power to its member owners at the lowest reasonable cost. As explained by Mr. Minson:

> Let me, if I can, express what AEPCO has done to reduce costs, because I think to phrase it as a mitigation may be out of context. It's our objective to make sure that the rural customer gets the lowest possible or reasonable cost and still maintain a financial viable organization.
>
> But in that context, we have renegotiated coal contracts, we have done a special voluntary retirement package, reducing our workforce from 315 to now 275. We have renegotiated 85% of our debt portfolio, driving the average cost from 8.1% now down to 6.1% over the last four years. We have tried, although as yet unsuccessfully, to renegotiate some purchase power contracts. Those are a few examples.[22]

As a result of these and other cost control measures, AEPCO has over the past ten years decreased its Class A member rates by more than 20% and hopes to continue these rate reductions, or at least maintain rate stability, in the future.[23]

CONCLUSION

AEPCO would request that the Commission amend its Rules in the three specific areas identified by AEPCO in its response to Question 1. AEPCO would also request that the Commission allow flexibility for it and its member distribution cooperatives to

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[22] HR TR, p. 3011, ll. 9 - 23.

[23] AEPCO Exhibit 3, p. 7, ll. 24 - 27.

pursue appropriate stranded cost requests in specific subsequent proceedings.

RESPECTFULLY SUBMITTED this 16th day of March, 1998.

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By [signature]
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Exhibit
A

MR. HEYMAN: Thank you.

HEARING OFFICER RUDIBAUGH: Michael, you were out of the room. Let me go off the record one quick second.

(Brief pause.)

HEARING OFFICER RUDIBAUGH: Let's take a ten-minute recess.

(A recess ensued.)

HEARING OFFICER RUDIBAUGH: Michael, we're ready for you.

CROSS-EXAMINATION

Q. (BY MR. GRANT) Dr. Cooper, good morning.

A. Good morning.

Q. My name's Mike Grant. I'm the attorney for the Arizona Electric Power Cooperative, which is a generation and transmission cooperative, and also two of its distribution cooperative members.

Are you familiar generally with cooperatives?

A. Yes, I'm quite familiar with them.

Q. And you know that they are customer owned/customer run organizations?

A. Yes.

Q. And let me ask you this general question and we can get into more detail if need be.

Cooperatives -- I realize that you have dealt generally with utilities in your testimony. By my count, about seven of the 12 affected utilities in the state are cooperatives.

Did you have cooperatives in mind in fashioning your testimony?

A. Well, cooperatives are different in the sense that as nonprofits, they have not been compensated for that risk. And that part of the argument is different.

Second of all, the notion of sharing breaks down in the sense that there are no stockholders with whom to share. So they are quite different.

If you will note that the constraint I place on the financial treatment of the utility had to do with the bondholder. And, of course, co-ops are almost 100 percent bondholders.

So the ability to -- downand no one there that has a -- is obligated, has a responsibility to step up and absorb some of the stranded costs. That doesn't mean there aren't uneconomic costs, because economic costs are part of the marketplace and not -- you know, they exist. That doesn't mean that ratepayers shouldn't find a way to not pay uneconomic costs. But the solution is just going to be fundamentally different.

Q. To the extent that cooperatives on a going-forward basis would be seeking precisely what they have sought in the past, that being basically to cover their operating costs, meet their mortgage covenants, and have sufficient additional funds for purposes such as working capital, those kinds of things, would it be appropriate, in your opinion, for the Commission to allow those on a going-forward basis the same as it has on a historic basis?

A. Well, again, I've advocated that the Commission cannot violate the bond covenants, anybody's bond covenants. And so I think that is going to constrain the Commission fundamentally in how they can deal with the co-ops.

At the same time, I think the co-ops need to recognize that when we get this vigorously competitive marketplace out here with a fairly low price of electricity, the ratepayers are going to look across the street and say, hey, guys, they're going to want those benefits, too, and downand going to be a tension on the co-ops, and I think the co-ops have recognized that.

I don't know that this Commission, because it does not -- it cannot forgive the bonds, for instance, it cannot force bondholders to eat those bonds, etc., that it has the ability to do an awful lot, and so the co-op solution may be in Washington as opposed to -- since that's where the bonds are established, because the state has not underwritten those bonds, the federal government has a role in co-op bonds.

So on the one hand, it's completely different. The Commission is going to be hard pressed to solve the problem.

On the other hand, I think your ratepayers are going to look out at that market and say: We ought to be able to get some benefits out of it, too.

Q. And from the standpoint that the ratepayers elect the members of the board of directors and those kinds of things, they certainly have ways in which to get those messages across to their consumer-owned organization?

A. Ultimately, the dollars are -- you can unelect folks, but they're still going to have to deal with those bondholders. So it's different,