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BEFORE THE ARIZONA CORPORATION COMMISSION

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JIM IRVIN  
COMMISSIONER--CHAIRMAN  
RENZ D. JENNINGS  
COMMISSIONER  
CARL J. KUNASEK  
COMMISSIONER

IN THE MATTER OF THE COMPETITION )  
IN THE PROVISIONS OF ELECTRIC )  
SERVICES THROUGHOUT THE STATE )  
OF ARIZONA )

DOCKET NO. RE-00000C-94-0165

NOTICE OF FILING

Citizens Utilities Company hereby provides Notice of Filing its Reply Brief as required by the Commission's Order in the above-referenced docket.

RESPECTFULLY SUBMITTED this 23rd day of March, 1998.

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Arizona Corporation Commission  
DOCKETED  
MAR 23 1998

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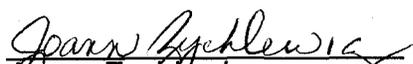
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3   JIM IRVIN  
4        COMMISSIONER--CHAIRMAN  
5   RENZ D. JENNINGS  
6        COMMISSIONER  
7   CARL J. KUNASEK  
8        COMMISSIONER

9  
10   IN THE MATTER OF THE COMPETITION    )   DOCKET NO. RE-00000C-94-0165  
11   IN THE PROVISIONS OF ELECTRIC        )  
12   SERVICES THROUGHOUT THE STATE       )   **CITIZENS UTILITIES COMPANY'S**  
13   OF ARIZONA.                            )   **REPLY BRIEF**  
14   \_\_\_\_\_  )  
15

16   **I.    INTRODUCTION.**

17        Citizens Utilities Company ("Citizens"), submits its reply brief in the above-captioned  
18   matter. Citizens received initial briefs from the following parties:

- 19        1.    The Attorney General of the State of Arizona ("AG");
- 20        2.    The Land and Water Fund of the Rockies, the Grand Canyon Trust, and
- 21            Arizonans for a Better Environment ("Law Fund");
- 22        3.    Arizonans for a Better Environment ("ABE");
- 23        4.    The City of Tucson ("Tucson");
- 24        5.    Arizona Consumers Council ("ACC");
- 25        6.    Arizona Community Action Association ("ACAA");
- 26        7.    Arizonans for Electric Choice and Competition, ASARCO Inc., and Cypress
- 27            Climax Metals Company ("AECC");

- 1 8. Ajo Improvement Company, Morenci Water & Electric Company and Phelps
- 2 Dodge Corporation ("Smith Clients")<sup>1</sup>
- 3 9. Arizona Electric Power Cooperative, Inc. ("AEPCO");
- 4 10. Navopache Electric Cooperative, Inc. ("Navopache");
- 5 11. The Department of Defense ("DOD");
- 6 12. Arizona School Boards Association ("ASBA");
- 7 13. PG&E Energy Services Corporation ("PG&E");
- 8 14. Arizona Public Service Company ("APS");
- 9 15. Tucson Electric Power Company ("TEP");
- 10 16. Electric Competition Coalition, Enron Corporation, and Enron Energy
- 11 Services, Inc. ("Enron");
- 12 17. Staff of the Arizona Corporation Commission ("Staff");
- 13 18. Residential Utility Consumer Office ("RUCO").

14 For the convenience of the Hearing Officer, Citizens will group together its replies by  
15 subject.

## 16 **II. THE REGULATORY COMPACT IS ALIVE AND WELL.**

### 17 **A. THE SUPERIOR COURT HAS NOT OVERRULED THE REGULATORY** 18 **COMPACT.**

19 Several parties argue that the recent decisions by Superior Court Judges Dann and  
20 Campbell somehow have determined that there is no regulatory compact.<sup>2</sup> Citizens will not  
21 give these strained interpretations of the rulings much space, because TEP has already  
22

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<sup>1</sup> These parties are represented by attorney Lex J. Smith.

<sup>2</sup> Tucson Brief, p. 16; Smith Clients Brief, pp. 2-4; Enron Brief, pp. 41-42; and Staff Brief, pp. 11-12.

1 thoroughly debunked them.<sup>3</sup> In fact, all that has been determined of relevance to this  
2 proceeding is that the regulatory compact does not prevent the Commission from opening  
3 up a utility's CC&N to competition as long as it meets the requirements of A.R.S. § 40-252.

4 **B. REPLY TO SMITH CLIENTS.**

5 The Smith Clients raise *Pennsylvania Electric Company v. Pennsylvania Pub. Util.*  
6 *Comm'n.*, 502 A.2d 130 (Pa. 1985), and *Duquesne Light Co. v. Barasch*, 489 U.S. 299  
7 (1989).<sup>4</sup> Neither case in any way suggests that the regulatory compact is imaginary. The  
8 first case involved recovery of assets damaged in a nuclear accident; the second involved  
9 assets found to no longer be used and useful in a regulated environment. It should not  
10 surprise this Commission (or Arizona utilities) that it can disallow recovery of investments in  
11 assets that were destroyed by utility negligence or have become no longer used and  
12 useful.<sup>5</sup> But what the regulatory compact would prevent would be an attempt by the  
13 Commission to change the rules of the game from monopoly regulation to competition and  
14 then to seek to charge utilities for the resulting stranded costs associated with prudent and  
15 "used and useful" investments.

16 The Smith Clients cite two cases allegedly for the proposition that regulators "have  
17 never protected -- as a constitutional right -- regulated industries from the effects of  
18 economic forces."<sup>6</sup> The cases do not support this proposition.

---

<sup>3</sup> TEP Brief, pp. 12-13.

<sup>4</sup> Smith Clients Brief, pp. 6-7.

<sup>5</sup> The Smith Clients Brief labors for five additional pages (17-22) to establish this conclusion. What the analysis never supports is that the Commission could abruptly move after 87 years from regulation to competition without honoring its obligation under regulation to allow utility investors the opportunity to earn a reasonable return on and return of prudent investments in used and useful utility assets.

<sup>6</sup> Smith Clients Brief, p. 7.

1           The first case cited was *Public Serv. Comm'n. of Montana v. Great Northern Utils.*  
2 *Co.*, 289 U.S. 130 (1933). The facts were that two gas utilities were competing under non-  
3 exclusive franchises for gas customers in Shelby, Montana.<sup>7</sup> There is no mention of a duty  
4 to serve imposed on either party. Great Northern Utilities Company freely chose to  
5 compete with other gas utilities. Under those circumstances, the Montana PSC clearly had  
6 no obligation to compensate Great Northern for its competitive losses.

7           The facts in *Market St. Ry. Co. v. Railroad Comm'n. of California*, 324 U.S. 548  
8 (1945) were similar. Market Street Railway had always competed against private  
9 automobiles (private carriages originally), taxis and foot travel. Even its trolley business  
10 was competitive; the City and County of San Francisco had operated a successful street  
11 railway business for the 33 years before the case was decided. Again, although the  
12 company was regulated, it was already operating in a competitive environment.

13           These cases provides no guidance concerning the Commission's obligation to  
14 compensate a utility -- burdened with the obligation to serve all customers, real and  
15 potential -- for the stranded costs resulting from the Commission's decision to open its  
16 certificated, exclusive service territory to competition.

17           **C.    REPLY TO STAFF.**

18           Staff's brief ignores the fact that its own witness admitted the existence of the  
19 regulatory compact and agreed to its parameters. Staff's witness is not alone. Citizens  
20 discussed in its brief the Hawaii Commission's recent affirmation of the "long-standing

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<sup>7</sup> 289 U.S. at 132.

1 regulatory compact.”<sup>8</sup> TEP lists nine other state commissions that have recognized its  
2 existence.<sup>9</sup>

3 Curiously, Staff states that: “The obligation to serve is a requirement of state law,  
4 not a contract term.”<sup>10</sup> This further concedes the need to compensate a utility for  
5 investments made as a requirement of state law. Unlike the former Soviet Union, the Due  
6 Process Clauses of the United States and Arizona Constitutions do not allow the State to  
7 impose an investment obligation upon a citizen, private or corporate, without just  
8 compensation.<sup>11</sup>

9 Staff also argues that utilities do not have a constitutional right to a continued  
10 monopoly.<sup>12</sup> Citizens has not claimed this and has not seen anyone else make this  
11 argument. Staff’s argument is accordingly moot. Staff also asserts that requiring mitigation  
12 of stranded costs is constitutionally allowable.<sup>13</sup> Again, no party has disputed a requirement  
13 for reasonable mitigation of stranded costs.

14 **D. REPLY TO AG.**

15 The AG maintains that

16 The Affected Utilities are saying that because they had to provide capacity, they are  
17 entitled to full stranded cost recovery . . . even if its choice of facility to generate was  
18 management error, and even if the shareholders assumed some of the risk.<sup>14</sup>  
19

---

<sup>8</sup> *In Citizens Utilities Company, Kauai Electric Division*, Docket Nos. 94-0097 and 94-0309, dated August 7, 1996, Slip Opinion at 20-21.

<sup>9</sup> TEP Brief, pp. 27-28.

<sup>10</sup> Staff Brief, p. 16.

<sup>11</sup> U.S. Const. amend V; Ariz. Const. art. II, Sec. 17.

<sup>12</sup> *Id.*, at 17-18.

<sup>13</sup> *Id.*, at 19-22.

<sup>14</sup> AG Brief, p. 30.

1 The AG provides no citation for this assertion, nor could it. No party, and certainly not  
2 Citizens, has made a claim that the regulatory compact would require such a result. But,  
3 where the Commission has passed on the prudence of the investment the regulatory  
4 compact does require reasonable compensation.

5 **E. REPLY TO AECC.**

6 AECC ignores the evidence over one hundred years of utility regulation that has long  
7 delineated the elements of the regulatory compact and purports that there is no evidence of  
8 an implied regulatory compact.<sup>15</sup> It labors mightily for four pages to support this surprising  
9 proposition,<sup>16</sup> but births only the tired conclusion that the regulatory compact does not bar  
10 the Commission from modifying a CC&N under certain very limited circumstances. AECC  
11 relies on *James P. Paul Water Co. v. Arizona Corporation Comm'n.*, 137 Ariz. 426 (1983)  
12 (*"James Paul Water"*) and *Appeal of Public Serv. Co. of New Hampshire*, 676 A.2d 101  
13 (N.H. 1996) (*"PSNH"*). *James Paul Water* actually hurts AECC. The case relies upon  
14 *Application of Trico Electric Cooperative, Inc.*, 92 Ariz. 373 (1962). (*"Trico"*). It explains the  
15 holding of *Trico* as follows:

16 In *Trico* we said a certificate holder was entitled to an opportunity to provide  
17 adequate service at a reasonable rate before a portion of its certificate could be  
18 deleted. A certificate holder is entitled to that opportunity because providing it with  
19 that opportunity serves the public interest.<sup>17</sup>  
20

21 The *Trico* Court went on to say:

22 The Commission was under duty to prohibit a [non-certificated] private utility under  
23 its jurisdiction from competing in that area, [certificated to another private utility],  
24 unless, after notice and an opportunity to be heard, it shall have been made to

---

15 AECC Brief, p. 24.

16 *Id.*, pp. 24-28.

17 *James Paul Water* at 428.

1 appear that [the certificate holder] failed or refused to render satisfactory and  
2 adequate service therein, at reasonable rates.<sup>18</sup>

3  
4 *PSNH* does hold under New Hampshire law that the New Hampshire Commission  
5 can award a competing franchise upon a finding that the public interest so warrants.  
6 However, *Trico* squarely prohibits the Arizona Commission from even going this far without  
7 a finding that the incumbent utility has failed or refused to render satisfactory and adequate  
8 service at reasonable rates.

9 **F. REPLY TO ABE.**

10 ABE embarks on a diatribe against the existing system of utility regulation.<sup>19</sup> Most of  
11 this is beside the point.<sup>20</sup> The Commission has determined that regulation of the generation  
12 market should be ended. Further, although ABE heaps scorn on the parameters of the  
13 regulatory compact, it admits that it has been a part of regulation. Nor does it present any  
14 evidence that utilities have been somehow over-compensated for the investments made  
15 under the regulatory compact.

16 **III. AUCTION AND DIVESTITURE WILL BEST VALUE STRANDED**  
17 **COSTS.**

18  
19 **A. REPLY TO SMITH CLIENTS.**

20  
21 The Smith Clients assert "that one common ground existed in the various utilities'  
22 presentations: they all endorse the use of the administrative net revenues lost

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<sup>18</sup> *Trico* at 387, n.2.

<sup>19</sup> ABE Brief, pp. 4-6.

<sup>20</sup> It is also flat-out wrong. For the best perspective on the hard choices faced by utility planners and commissions in the 1970s, see Mr. Bayless' testimony and accompanying exhibits. TEP-9 through TEP-12. At that time of double-digit load growth, there were simply no alternatives to large coal and nuclear-fueled generating stations.

1 approach...<sup>21</sup> This is wrong. Citizens has vigorously advocated for the auction and  
2 divestiture approach since the early days of the working groups. The two Smith utility  
3 clients would also be surprised to find that their attorney believes that they have advocated  
4 the net revenues lost method.

5 **B. REPLY TO AECC.**

6 AECC has raised a new method for calculating stranded costs: a hybrid of the net  
7 revenues lost and replacement cost methodologies.<sup>22</sup> Citizens incorrectly believed that it  
8 had already seen the two most complex methodologies: net revenues lost and replacement  
9 cost. By combining the two, AECC would create the new champion of complexity: its  
10 hybrid approach. This would be the mother of all attorney full-employment methodologies.  
11 Further, AECC does not explain how purchased power contracts would be valued.

12 Fortunately, AECC recognizes that "[a]uction and divestiture is conceptually the best  
13 method for determining overall stranded costs...<sup>23</sup> This is the general consensus of the  
14 parties. The single objection raised by AECC and other parties to the auction and  
15 divestiture method is a perceived problem with nuclear assets ownership.<sup>24</sup> This problem is  
16 not insurmountable. In its brief, Citizens discussed how the use of power purchase  
17 agreements with these assets could solve even the ownership problem.<sup>25</sup>

---

21 Smith Clients Brief, p. 14.

22 AECC Brief, pp. 11-12.

23 *Id.* at 6.

24 *Id.* at 7.

25 Citizens Brief, p. 15.

1           **C.     REPLY TO AG.**

2           The AG has largely abandoned its proposal of somehow determining stranded costs  
3 by observing the market's reaction to old and new utility securities. For Citizens, the AG  
4 now accepts divestiture as the appropriate stranded cost valuation. But the AG would still  
5 append one vestige of its discredited methodology to the auction and divestiture approach.  
6 The AG would offset stranded costs by the allegedly-determinable stock-market gains  
7 associated with being compensated for stranded costs.<sup>26</sup> This approach would be unfair  
8 and also would not work.

9           Investors never expected to earn anything from the liabilities associated with power  
10 purchase agreements. These were entered into under the jurisdiction and supervision of  
11 the Federal Energy Regulatory Commission. They were then approved by the Corporation  
12 Commission for pass-through in Citizens' Purchased Power and Fuel Adjustment Clause.  
13 Cost decreases have been passed through dollar-for-dollar to Citizens' customers.  
14 Shareholders have earned nothing on these costs.

15           It is possible that parties in this case have now frightened investors with the prospect  
16 of unlawfully depriving them of recovery of these prudent costs. If so, it is further possible  
17 that Citizens' stock market valuation may have been somewhat reduced. Extending the  
18 parade of "ifs" even further, it would then be possible that investors could be relieved when  
19 it turned out they were actually allowed to recover their costs. In this extended hypothetical,  
20 Citizens market valuation could then possibly recover. However, the associated gains  
21 would not be something unfair that was created by the onset of competition, only the

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<sup>26</sup> AG Brief, pp. 15, 16.

1 recovery of market value lost by challenges to lawful recovery. Finally, all this assumes  
2 further that it were possible to actually directly measure stock market gains associated with  
3 one event.

4 For a company like Citizens, with a portfolio of regulated businesses operating in  
5 over 20 states, it would be impossible to associate the market's performance on a particular  
6 day with the divestiture of above-market power purchase arrangements. In addition to all  
7 the factors that might affect the overall stock market performance on one day (e.g.,  
8 employment figures, inflation news, a new bimbo eruption or Alan Greenspan's mood),  
9 other Citizens-specific news could raise or lower Citizens' stock. Further, how would the  
10 time period be selected? Would the Commission announce ahead of time that some  
11 percentage of all gains on a particular date or dates would be returned to customers? If so,  
12 this would almost guarantee no gains for that time period because no one would buy the  
13 stock. Alternatively, would the Commission be expected to look back after the fact and  
14 appropriate gains for a particular date or dates that were administratively determined to be  
15 associated with divestiture? This begs the questions of what dates and how much? And  
16 how would these fairly be set?

17 The AG's stock-market offset is simply unworkable.

18 **D. REPLY TO STAFF.**

19 Staff would hang on to the requirement for a stranded cost filing even though it would  
20 not use the results of the filing for any meaningful purpose.<sup>27</sup> Staff would only allow  
21 "transition revenues" to financially distressed utilities, sufficient to keep them from

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<sup>27</sup> Staff Brief, pp. 4-10, 24-27.

1 bankruptcy during the transition to competition. A financially healthy utility would recover  
2 none of its stranded costs, regardless of the magnitude. Again, this type of an approach is  
3 reminiscent of the old Soviet Union: "From each according to his ability; to each according  
4 to its need." Staff has pointed to no United States authority that supports its theory that it is  
5 permissible to expropriate the property of a citizen as long as the citizen is not destitute as  
6 result.

7 **E. REPLY TO RUCO.**

8 RUCO asserts that the auction and divestiture methodology would require the  
9 Commission to conduct a post-auction proceeding to "evaluate the reasonableness of the  
10 result."<sup>28</sup> This is apparently based upon RUCO's reading of the requirement that  
11 Commission decisions be based upon substantial evidence.<sup>29</sup> Citizens does not believe  
12 that this requirement, which is shared by utility regulators around the country, would in any  
13 way bar the use of the auction and divestiture methodology. For example, the Federal  
14 Energy Regulatory Commission has successfully deregulated the interstate sale and  
15 transmission of both gas and electricity by concluding -- after taking extensive evidence and  
16 reviewing thousands (perhaps millions) of pages of legal argument -- that a fully-functioning  
17 competitive market will result in just and reasonable rates.

18 The Commission should adopt the auction and divestiture methodology as its  
19 preferred approach. It is simple, moves rapidly to competition, avoids market power  
20 concerns and eliminates the need for lengthy, contested stranded cost and true-up  
21 proceedings.

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<sup>28</sup> RUCO Brief, p. 9.

1 **IV. PRICE CAPS SHOULD ONLY APPLY TO COMPETITIVE SUPPLY**  
2 **COSTS AND SHOULD NOT BE ALLOWED TO ABRIDGE RECOVERY**  
3 **OF PRUDENTLY-INCURRED STRANDED COSTS.**  
4

5 Many parties advocate price caps during the transition to competition.<sup>30</sup> Price caps  
6 have a certain facile attraction, but may actually be thinly-veiled attempts to prevent  
7 stranded cost recovery. For instance, if the Commission were to allow a utility to recover its  
8 stranded costs over a certain time period, a corresponding price cap during that period  
9 could prevent complete recovery.

10 Further, if a price cap is put in place, it can only be set on the unregulated, supply  
11 portion of rates. The remaining LDC must be allowed to recover its prudently-incurred  
12 costs; anything else would be illegal. This is particularly important for Citizens. Because it  
13 has historically controlled its costs, its residential electric rates are already among the  
14 lowest in Arizona. But it must invest capital to meet the rapid growth it is experiencing,  
15 particularly in Mohave County. Citizens is constitutionally entitled to a fair return on and of  
16 the investment needed to satisfy this growth.

17 **V. CITIZENS' BURDEN OF PROOF ALLOCATIONS ARE PROPER.**

18 The Smith Clients<sup>31</sup> objected to Citizens' discussion of the proper burdens of proof  
19 concerning the amount of unmitigable stranded costs and the propriety of mitigation  
20 measures taken. Citizens proposed that, once a utility files an acceptable estimate of  
21 stranded costs, unmitigated stranded costs would be deemed fully recoverable unless a

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<sup>29</sup> *Id.*, pp. 28-29.

<sup>30</sup> Tucson Brief, pp. 13-14; ACC Brief p. 2; ACAA Brief, p. 3; AECC Brief, pp. 20-21; Smith Clients Brief, p. S-2; DOD Brief, pp. 13; PG&E Brief p. 13; Staff Brief, pp. 27-28; and RUCO Brief, pp. 4, 27-28.

<sup>31</sup> Smith Clients Brief, pp. 11-14.

1 party could demonstrate the Affected Utility did not make reasonable mitigation efforts.  
2 Calculation methodologies would still be subject to scrutiny, but past management  
3 decisions, already reviewed by the Commission, would not be subject to the challenge. The  
4 Smith Clients would shift the burden of proof to require a utility to reprove the prudence of  
5 investments or costs already deemed prudent. This is simply another back-door method to  
6 disallow recovery of stranded costs.

7 Citizens did not state that the burden of proof should be on those that object to  
8 mitigation measures. Rather, Citizens stated that to allow the Commission to judge the  
9 reasonableness of mitigation efforts, each Affected Utility should make a showing of all  
10 mitigation measures it has taken, the results of those measures, and an explanation of  
11 measures considered but rejected. The burden of proof that the Affected Utility in fact did  
12 not make adequate mitigation efforts would then fall on the party seeking denial of full  
13 recovery of the stated level of unmitigated stranded costs. This is no more than the  
14 traditional shifting of the burden of proof that occurs in courtrooms and administrative  
15 hearings every day. Citizens was asking for no more.

16 Further, Citizens objected to the Rules' requirement that the "Affected Utilities shall  
17 take every feasible, cost-effective measure to mitigate or offset Stranded Costs." This is an  
18 impossible standard to meet. Under this standard the Commission would guarantee that an  
19 enormous number of alternative mitigation measures, based on 20-20 hindsight and fertile  
20 imaginations, will solemnly be offered by competing experts that have never had to actually  
21 operate generating assets or purchase electricity.

22 At a minimum, the Commission should clarify that the standard for judging mitigation  
23 measures will be the traditional standard for evaluating management decisions -- Was

1 management's decision reasonable, based on the facts and circumstances known at the  
2 time? For the decision to be reasonable it would not be required to be the best available,  
3 only that reasonable minds might have made the same decision.

4 **VI. ALL CUSTOMERS SHOULD PROVIDE STRANDED-COST**  
5 **RECOVERY.**

6  
7 ASBA seeks to exempt schools from responsibility for stranded cost recovery. It  
8 presents no evidence or argument why schools should be afforded a preference over any  
9 other political entity, house of worship or civic group. ASBA would start down a slippery  
10 slope that would likely lead to only residential customers holding the bag. All customers  
11 should be responsible for stranded-cost recovery.

12 **VII. LDCS MUST BE ALLOWED TO RECOVER COMPETITIVE**  
13 **TRANSITION COSTS.**

14  
15 The AG<sup>32</sup> misses the point on the going-forward costs discussed by Citizens. The  
16 LDC, which will still be regulated, will incur very real costs, such as for metering, customer  
17 education efforts, and new computer systems. Some of these will be one-time; some will  
18 be ongoing. Citizens only point was that, to the extent the regulated LDC will be required to  
19 bear these costs as part of the transition to competition, it should fairly be allowed the  
20 opportunity to recover these costs in its rates. These costs have nothing to do with the  
21 various costs that APS seeks to recover over the next eight years in its pseudo net-  
22 revenues-lost methodology.

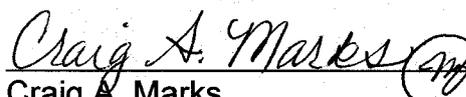
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<sup>32</sup> AG Brief, p. 9.

1 **VIII. CONCLUSION.**

2 Citizens proposal has balanced the interests of the utilities and their customers,  
3 would move rapidly toward full competition, would avoid contentious litigation and would  
4 properly value stranded costs. The Commission should adopt this reasoned approach.

5 RESPECTFULLY SUBMITTED this 23<sup>rd</sup> day of March, 1998.

6  
7   
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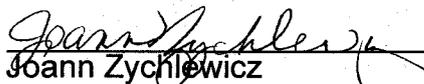
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