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BEFORE THE ARIZONA CORPORATION COMMISSION

~~Arizona Corporation Commission~~

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JIM IRVIN  
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Commissioner

CARL J. KUNASEK  
Commissioner

MAR 23 1998

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

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

ARIZONA ELECTRIC POWER  
COOPERATIVE, INC.'S  
REPLY BRIEF

Pursuant to the Procedural Order dated March 3, 1998,  
Arizona Electric Power Cooperative, Inc. ("AEPKO") submits this  
Reply Brief in relation to the above entitled matter.

INTRODUCTION

Having reviewed the voluminous initial filings, AEPKO  
believes a second fact has been established beyond any doubt:  
Forests worldwide will heave a collective sigh of relief upon  
conclusion of this proceeding. In this Reply, AEPKO will labor  
mightily to be brief and succinct so as not to prolong this  
environmental uncertainty.

In the Initial Briefs, no party has challenged the basic  
proposition which formed the core of AEPKO's opening memorandum:  
Cooperatives are different. Briefly to restate:

- Cooperatives are customer owned organiza-  
tions. There is no shareholder to  
"stick" with stranded costs. To the  
extent the Commission disallows stranded  
costs, it either takes from the current  
customer that equity which it has  
provided in the past and had a right to  
receive in the future and/or, in AEPKO's  
case, increases the negative equity which  
must be provided by the customer.

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- Cooperatives have no profit motive. Although AEPCO does not agree with assertions that utilities historically have been compensated for the risk of a potential breach of the regulatory compact, such assertions in the case of cooperatives are simply irrelevant because a risk premium has never been sought nor granted in their rates.<sup>1</sup>
- Cooperatives are customer managed organizations. Customers elect and serve on their boards of directors. "Mitigation" concerns are nonexistent because the customers themselves review and direct the cooperatives' progress and efforts toward their only mission: To deliver reliable power at the lowest reasonable cost.
- Cooperatives are highly leveraged, debt financed organizations. This reduces their costs, but allows little room to absorb disallowed stranded costs and maximizes the possibility of debt default if adequate stranded costs are not allowed.<sup>2</sup>

No Initial Brief has called these cooperative concepts and realities into question.

Much has been made and much has been written of the "regulatory compact" in this case. AEPCO firmly believes that there is a regulatory compact. In one of many appellate decisions which confirm its existence, the Supreme Court stated, in relation to a cooperative, that by the issuance of a Certificate of

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<sup>1</sup> "Well, cooperatives are different in the sense that as nonprofits, they have not been compensated for that risk." Testimony of Dr. Cooper, HR TR p. 2520, ll. 9-11.

<sup>2</sup> "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." Testimony of Dr. Cooper, HR TR p. 2521, ll. 4-18.

1 Convenience and Necessity, the state contracts that if the utility  
2 will make adequate investment and render competent and adequate  
3 service, it will have the privilege of a monopoly. Its rights are  
4 vested and protected by Article 2, Section 17:

5 We hold that the Corporation Commission was  
6 under a duty to Trico to protect it in the  
7 exclusive right to serve electricity in the  
8 region where it rendered service, under its  
9 Certificate.<sup>3</sup>

10 AEPCO and its member distribution cooperatives, relying on this  
11 compact, contract, bargain, deal or promise, have constructed over  
12 much of this century a system which legally and economically was  
13 grounded on this premise. Both horizontally and vertically,  
14 customers banded together cooperatively to deliver power to each  
15 other in high cost areas of this state which had not been served  
16 by others. The Commission's Rules continue to rely on this  
17 structure to assure that no customer will be left unserved by this  
18 great competition experiment.<sup>4</sup>

19 AEPCO does not ask the Commission to decide this debate  
20 over the regulatory compact in the context of this generic  
21 proceeding. It does request that the Commission enter an Order  
22 and process specific requests in such a manner that cooperatives

23 <sup>3</sup> Application of Trico Electric Cooperative, 92 Ariz. 363,  
24 377 P.2d 309, 319 (1962). Specifically, AEPCO does not waive its  
25 right to seek adequate compensation for loss of its property  
26 rights by participation in "stranded cost" proceedings.

27 <sup>4</sup> R14-2-1606.A provides, in pertinent part, as follows:  
28 "Until the Commission determines that competition has been  
substantially implemented . . . each [cooperative] shall make  
available to all consumers . . . in its service area, as defined  
on the date indicated in R14-2-1602, Standard Offer bundled  
generation, transmission, ancillary, distribution, and other  
necessary services at regulated rates."

1 will continue to be able to meet their responsibilities under the  
2 Rules and, more importantly, their obligations and duties to their  
3 customer owners.

4 AEPCO will focus the remainder of its Reply on four key  
5 issues. Its failure to address any particular party's suggestion  
6 should not be construed as endorsement or approval of it.

7 I. RULES AMENDMENTS.

8 The Initial Briefs have identified dozens of potential  
9 amendments to the Rules. Of greatest concern is Staff's  
10 recommendation that R14-2-1607.A and I be modified to provide that  
11 stranded cost recovery is permissive rather than mandatory. What  
12 Staff suggests is that the Commission alter the Rules' guarantee  
13 of stranded cost recovery substituting instead an undefined  
14 "transition revenues" approach. The FASB 71 consequences of that  
15 recommendation could be enormous. AEPCO outlined the perils  
16 associated with such an amendment in both its prefiled testimony  
17 as well as its Initial Brief.<sup>5</sup>

18 Staff's recommendation is inconsistent with its prior  
19 position in this docket and, in fact, constitutes a collateral  
20 attack on Decision No. 59943. During Rules' consideration, RUCO  
21 suggested as - Staff does now - that the rule should "indicate  
22 that there is no guarantee of recovery of stranded costs. . . ."  
23 Appendix B to that Decision, the Concise Explanatory Statement  
24  
25

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26 <sup>5</sup> AEPCO Exhibit 4, pp. 2-5 and AEPCO's Initial Brief,  
27 pp. 8-9. See also TEP Initial Brief at pp. 17-19 for a discussion  
28 of FASB 71 concepts.

1 prepared by Staff, rejects at page 47, lines 6-8, this precise  
2 point:

3 The Rule does guarantee recovery of  
4 unmitigated Stranded Cost, but also provides a  
5 process for determining the magnitude of  
6 Stranded Cost, and recovery mechanisms and  
7 charges. Input from various parties as to  
8 that magnitude is provided and encouraged.

9 Resolution: No amendment to the Rule is necessary.

10 Staff's recommendation is also dangerous. In essence,  
11 it invites the Commission to enter an Order which concludes that  
12 stranded costs should not be allowed, but an ill-defined level of  
13 "transition revenue" based upon criteria yet to be determined may  
14 be allowed. Such an Order would not offer sufficient probability  
15 of recovery or assurance of adequate cash flows to avoid major  
16 writeoffs and writedowns.<sup>6</sup>

17 Finally, Staff's recommendation is unnecessary.  
18 R14-2-1607 currently affords the Commission sufficient flexibility  
19 to deal with specific stranded cost requests on a variety of  
20 different issues without running the risk of the FASB 71  
21 consequences identified above. This is precisely what the  
22 Commission said in Decision No. 59943 only fifteen months ago.

23 In general, AEPCO does not believe that extensive  
24 amendments to R14-2-1607 are necessary. It has recommended three  
25 amendments at pages 4 to 5 of its Initial Brief. Extensive  
26 additional amendments will simply delay progress toward specific  
27 stranded cost proceedings.

28 . . .

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<sup>6</sup> McKnight Testimony, HR TR pp. 2400-2403.

1 **II. STRANDED COST FILING TIMING.**

2 The Initial Briefs indicate a fair amount of consensus  
3 that specific stranded cost filings should be made promptly.  
4 Assuming prompt entry of an Order in this proceeding, AEPCO's  
5 recommendation of a stranded cost filing within ninety days should  
6 allow the Commission and Staff adequate time to evaluate its  
7 request prior to January 1, 1999.

8 Once again, on behalf of its member distribution  
9 cooperatives, AEPCO would recommend that the Commission not adopt  
10 any filing deadline which would preclude subsequent requests for  
11 stranded cost recovery as the competitive market develops.

12 **III. CALCULATION METHODOLOGY AND MARKET PRICE.**

13 Calculation methodology is probably the most contentious  
14 issue involved in this proceeding. Various parties have argued  
15 the merits and demerits of administrative approaches, market  
16 valuation approaches and divestiture methods. However, no Initial  
17 Brief took issue with AEPCO's recommendation that the "net  
18 revenues lost" method is particularly well-suited for it as a  
19 cooperative.

20 For example, a primary concern of those assailing the  
21 "net revenues lost" approach is that it affords insufficient  
22 incentive for utilities to mitigate their stranded costs.  
23 Although AEPCO does not accept that criticism generally,<sup>7</sup> the  
24 argument is simply not applicable to customer managed  
25

26  
27 <sup>7</sup> See, for example, the cross-examination of Mr. Davis at  
28 HR TR p. 3691, l. 20 to p. 3693, l. 21.

1 cooperatives. Mr. Higgins of Arizonans for Electric Choice  
2 agreed:

3 Q. (By Mr. Grant) I think you expressed  
4 mitigation as being . . . one of your  
5 main concerns [about the net revenues  
6 lost method].

7 You are aware, are you not, that in a  
8 cooperative the customers are electing  
9 its board of directors?

10 Are you aware of that?

11 A. Yes, I am aware of that.

12 Q. And the board of directors, obviously,  
13 can direct and control, can it not, the  
14 level of mitigation activities that the  
15 cooperative undertakes?

16 A. That would -- in general I would agree,  
17 yes.<sup>8</sup>

18 AEPCO outlined at pages 1-3 and 6-9 of its Initial Brief the  
19 parties' general agreement that cooperatives appropriately should  
20 be treated differently for stranded cost recovery purposes and the  
21 fact that the "net revenues lost" calculation methodology would be  
22 appropriate for AEPCO. Nothing in the Initial Briefs countered  
23 this conclusion.

24 Several parties continue to recommend forced divestiture  
25 as a "calculation methodology." However, no one offers any  
26 authority for the Commission's ability to order divestiture  
27 because none exists. To the contrary, as the Supreme Court noted  
28 in Southern Pacific Co. v. Ariz. Corp. Comm'n, 98 Ariz. 339, 341,  
404 P.2d 692, 694 (1965), "plainly it is not the purpose of  
regulatory bodies to manage the affairs" of the utility. Our

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27 <sup>8</sup> HR TR p. 4118, ll. 4-17.

1 Supreme Court then quoted favorably from a United States Supreme  
2 Court decision:

3 It must never be forgotten, that while the  
4 state may regulate with a view to enforcing  
5 reasonable rates and charges, it is not the  
6 owner of the property of public utility  
7 companies, and it is not clothed with the  
8 general power of management incident to  
9 ownership. Southern Pacific, id. (Emphasis  
10 supplied.)

11 Placing this insurmountable jurisdictional obstacle to one side,  
12 the testimony also highlighted the many practical obstacles  
13 associated with divestiture. Much of this testimony reinforced  
14 the disadvantages of divestiture which were outlined at page 25 of  
15 the Stranded Cost Working Group Report:

- 16 ● Costs for preparing the assets for sale  
17 and administering the auctions are  
18 difficult to predict, but will certainly  
19 add to the stranded cost totals.
- 20 ● A forced sale of all assets within a very  
21 short time frame may lead to "fire sale"  
22 prices.
- 23 ● Uncertainty exists with respect to how  
24 many parties might participate in an  
25 auction of generating assets in Arizona.
- 26 ● Tremendous administrative hurdles such as  
27 unwinding current power supply contracts,  
28 soliciting stockholder approvals, and  
obtaining the releases of mortgaged  
property from bond trustees will be very  
complicated, costly, and time consuming.
- The Commission lacks the authority to  
order such asset sales and divestiture.
- Given the great uncertainty that  
presently exists with respect to the  
future competitive retail electric  
market, such action may not produce more  
accurate estimates of stranded costs.

- 1                   ●     There are substantial restrictions under  
2                   the Atomic Energy Act and Nuclear  
3                   Regulatory Commission regulations on the  
4                   transfer of the ownership and operating  
5                   licenses of nuclear generating facilities  
6                   that will severely limit the field of  
7                   potential bidders.
- 8                   ●     The new open-access transmission rules  
9                   sufficiently mitigate the potential for  
10                  exercising market power in generation,  
11                  thereby rendering moot a perceived key  
12                  benefit of auctions.

13                  With particular reference to AEPCO's lienholders,  
14                  divestiture proponents admitted that they had no information  
15                  concerning the difficulties AEPCO would face in attempting to  
16                  secure releases on its assets.<sup>9</sup> Mr. Minson elaborated:

17                  A mandatory divestiture in AEPCO's case would be  
18                  a very complicated, drawn out, expensive  
19                  process because of the -- if, for no other  
20                  reason, than the one major lienholder that we  
21                  have, which is the United States government,  
22                  and I believe that undertaking a forced  
23                  divestiture, the United States government,  
24                  through the Rural Utility Service, would  
25                  necessarily be heavily involved. There are  
26                  certain requirements that they will have, to  
27                  say nothing of the other debtholders of AEPCO.

28                  And I believe it would probably be  
29                  complicated, too, by the fact that we have six  
30                  owners in the form of Class A members, we also  
31                  have a Class B and Class C member.<sup>10</sup>

32                  Mr. Edwards of the Cooperative Finance Corporation also testified  
33                  concerning divestiture obstacles and disadvantages that would face  
34                  AEPCO:

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35                  <sup>9</sup>     Breen Testimony, pp. 151 to 152; Petrochokow Testimony,  
36                  pp. 944 to 946; Nelson Testimony, pp. 4233 to 4234; and Ogelsby  
37                  Testimony, pp. 1335 to 1336.

38                  <sup>10</sup>    HR TR p. 3024, l. 16 to p. 3025, l. 4.

1 One, it would -- to me, it would certainly be  
2 difficult to unwind the debt. A lot of  
3 AEPCO's debt is FFB, government RUS type debt.  
4 There is a fair amount of Co-Bank, CFC and  
5 other sources.

6 A lot of the government debt is fairly old,  
7 and its at what has been referred to as  
8 subsidized rates, or certainly at lower  
9 interest rates than what the replacement value  
10 would be today. So the opportunity cost of  
11 replacing that debt would be substantial.

12 Additionally, the FFB debt, which is the  
13 largest component of AEPCO's debt structure,  
14 typically has prepayment penalties associated  
15 with it. That, in conjunction with the  
16 opportunity costs make it extraordinarily  
17 difficult to get out from underneath that debt  
18 on an early basis, as a divestiture would  
19 require. So unwinding that debt is very  
20 difficult.

21 I would also agree with Dr. Rosen that if  
22 there are few bidders in a bid, a forced  
23 divesture, that may lead to an inappropriate  
24 market concentration of assets. And I also  
25 would tend to agree that although you could  
26 probably structure a bid whereby the amount of  
27 assets were not -- did not affect the bid per  
28 se, it would be difficult to have a lot of  
confidence in that. So it may not express the  
value [of the plant being sold].<sup>11</sup>

18 Auction and divesture is not a rational way to approach the  
19 calculation of stranded costs. It is beyond the Commission's  
20 jurisdiction and, specifically, makes no sense in AEPCO's case.

21 As to market price, AEPCO feels that issue should be  
22 left to the utility specific proceeding. However, in general, it  
23 agrees with concerns expressed by many that a purely short term or  
24 "spot market" price is not the appropriate measure for calculating  
25 stranded costs.

26  
27 <sup>11</sup> HR TR p. 2050, l. 4 to p. 2051, l. 5.

1 **IV. PRICE CAPS/RATE FREEZE.**

2 Based upon review of the Initial Briefs, a rate freeze  
3 has been universally rejected by the parties. However, a price  
4 cap continues to be suggested by certain parties. None of them  
5 offer any legal authorities in support the Commission's ability to  
6 impose such a cap.

7 Indeed, RUCO argues completely inconsistently. On the  
8 one hand, it argues persuasively that the fair value determination  
9 mandated by Arizona's Constitution requires consideration of all  
10 relevant factors at the time of a rate inquiry. But then almost  
11 immediately RUCO recommends a pre-determined rate cap which would  
12 ignore that constitutional standard.<sup>12</sup>

13 There also has been no clearly articulated need stated  
14 for a price cap. The Commission retains control over the Standard  
15 Offer Rate and the unbundled rates. To the extent that a consumer  
16 tries and does not like the competitive generation rate, the  
17 customer may simply return to the safe harbor of the regulated  
18 Standard Offer rate. The Commission should reject suggestions of  
19 a rate cap.

20 **CONCLUSION**

21 It is time for AEPCO and the other Affected Utilities to  
22 move forward with specific stranded cost filings. AEPCO is  
23 prepared to submit a stranded cost request based on the "net  
24 revenues lost" methodology within ninety days of the effective  
25 date of the Order.

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<sup>12</sup> RUCO Initial Brief, pp. 26 to 28.



1  
2 Original and ten copies of the  
3 foregoing filed this 22<sup>nd</sup> day of  
4 March, 1998, with:

5 Docket Control Division  
6 Arizona Corporation Commission  
7 1200 West Washington  
8 Phoenix, Arizona 85007

9 Copy of the foregoing mailed  
10 this 23<sup>rd</sup> day of March, 1998 to:

11 Michael A. Curtis, Esq.  
12 Martinez & Curtis, P.C.  
13 2712 North 7th Street  
14 Phoenix, Arizona 85006  
15 Attorneys for Mohave Electric  
16 Cooperative, Inc. and AMPUA

17 Mr. Walter W. Meek  
18 Arizona Utility Investors Association  
19 2100 North Central Avenue  
20 Suite 210  
21 Phoenix, Arizona 85004

22 Mr. Norman J. Furuta  
23 Department of the Navy  
24 900 Commodore Drive, Building 107  
25 P.O. Box 272 (Attn: Code 90C)  
26 San Bruno, California 94066-0720

27 Lex J. Smith, Esq.  
28 Brown & Bain, P.A.  
29 2901 North Central Avenue  
30 P.O. Box 400  
31 Phoenix, Arizona 85001-0400  
32 Attorneys for Phelps Dodge

33 Bradley S. Carroll, Esq.  
34 Tucson Electric Power  
35 220 West Sixth Street  
36 Legal Department  
37 P.O. Box 711  
38 Tucson, Arizona 85702

39 Douglas C. Nelson, Esq.  
40 Douglas C. Nelson P.C.  
41 7000 North 16th Street  
42 Suite 120-307  
43 Phoenix, Arizona 85020

Mr. Ken Saline  
K.R. Saline & Associates  
160 North Pasadena  
Suite 101  
Mesa, Arizona 85201

C. Webb Crockett, Esq.  
Fennemore Craig  
3003 North Central Avenue  
Suite 2600  
Phoenix, Arizona 85012  
Attorneys for Asarco, Inc.,  
Cyprus Climax Metals Co.,  
Enron, Inc., and AAEC

Mr. Sam DeFrawi  
Department of Navy  
Naval Facilities  
Engineering Command  
Navy Rate Intervention  
901 M Street SE, Bldg. 212  
Washington, D.C. 20374

Robert S. Lynch, Esq.  
340 East Palm Lane, #140  
Phoenix, Arizona 85004  
Attorneys for ATDUG

Ms. Barbara Klemstine  
Arizona Public Service  
Station 9909  
P.O. Box 53999  
Phoenix, Arizona 85072

Lawrence V. Robertson, Esq.  
Munger Chadwick P.L.C.  
333 North Wilmot  
Suite 300  
Tucson, Arizona 85722  
Attorneys for PGE Energy

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Craig Marks, Esq.  
Citizens Utilities Company  
2901 North Central Avenue, #1660  
Phoenix, Arizona 85012

Suzanne Dallimore, Esq.  
Office of the Attorney General  
1275 West Washington Street  
Phoenix, Arizona 85007

Steven Wheeler, Esq.  
Thomas M. Mumaw, Esq.  
Snell & Wilmer  
One Arizona Center  
400 East Van Buren Street  
Phoenix, Arizona 85004  
Attorneys for APS

Jesse Sears, Esq.  
Office of the City Attorney  
200 West Washington Street  
Suite 1300  
Phoenix, Arizona 85003

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

Andrew Bettwy, Esq.  
Southwest Gas Corporation  
5241 Spring Mountain Road  
Las Vegas, Nevada 89102

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

Paul Bullis, Esq.  
Chief Counsel  
Legal Division  
Arizona Corporation Commission  
1200 West Washington  
Phoenix, Arizona 85007

Mr. Vinnie Hunt  
City of Tucson  
Department of Operations  
4004 South Park Avenue  
Tucson, Arizona 85714

Ms. Betty Pruitt  
ACAA  
202 East McDowell Road, #255  
Phoenix, Arizona 85004

Ms. Elizabeth S. Furkins  
IBEW  
750 South Tucson Boulevard  
Tucson, Arizona 85716

Mr. Carl Dabelstein  
2211 East Edna Avenue  
Phoenix, Arizona 85022

Russell E. Jones, Esq.  
O'Connor Cavanagh  
Molloy Jones  
33 North Stone Avenue, #2100  
Tucson, Arizona 85702

Myron L. Scott, Esq.  
1628 East Southern Avenue  
Suite No. 9-328  
Tempe, Arizona 85282  
Attorneys for ABE

Barbara R. Goldberg, Esq.  
Office of the City Attorney  
3939 Civic Center Boulevard  
Scottsdale, Arizona 85251

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

Mr. Michael K. Block  
The Goldwater Institute  
201 North Central Avenue  
Phoenix, Arizona 85004

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21  
22  
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28

Director - Utilities Division  
Arizona Corporation Commission  
1200 West Washington  
Phoenix, Arizona 85007

Deborah Scott, Esq.  
RUCO  
2828 North Central Avenue  
Suite 1200  
Phoenix, Arizona 85004

*D. Hill*  
\_\_\_\_\_

0522606

Thomas W. Pickrell, Esq.  
Arizona School Board Assoc.  
2100 North Central Avenue  
Phoenix, Arizona 85004

Mr. Rick Gilliam  
Land and Water Fund  
2260 Baseline Road, #200  
Boulder, Colorado 80302