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March 23, 1998

Docket Control
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, Arizona 85007

Re: Docket No. RE-0000-C-94-0165

Dear Sir or Madam:

During the Stranded Cost hearings of February 23, 1998, all parties were directed to file their reply briefs on or before 4:00 P.M. on March 23, 1998. Enclosed are the reply briefs for Arizona Public Service Company.

If you have any questions, please contact me at 250-2031.

Sincerely,

Barbara A. Klemstine, MRE

Barbara A. Klemstine
Manager
Regulatory Affairs

BAK/JKD/pb

Enclosures

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BEFORE THE ARIZONA CORPORATION COMMISSION

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

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

DOCKET NO. RE-00000C-94-0165

REPLY BRIEF OF

ARIZONA PUBLIC SERVICE COMPANY

ON GENERIC STRANDED COST

ISSUES

March 23, 1998

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BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
COMMISSIONER - CHAIRMAN
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CARL J. KUNASEK
COMMISSIONER

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

DOCKET NO. RE-00000C-94-0165

REPLY BRIEF OF ARIZONA PUBLIC SERVICE COMPANY ON GENERIC STRANDED COST ISSUES

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Pursuant to the Chief Hearing Officer's direction herein, Arizona Public Service Company ("APS" or "Company") hereby submits its Reply Brief to certain of the generic stranded costs issues raised by other parties' initial briefs in this proceeding. As noted hereinafter, the Company's failure to address an issue does not necessarily imply either agreement or indifference and does not in any way constitute a waiver of APS' rights.

I. INTRODUCTION

APS respectfully asks the Chief Hearing Officer to consider several salient points regarding the various proposals to automatically (and in APS' view arbitrarily and unlawfully) disallow a portion of otherwise documented, verifiable and non-mitigatable stranded costs. The Company believes that such proposals must be critically examined in the historical context of this Commission's prior actions.

First, in issuing Decision No. 59943 (December 26, 1996) adopting the Electric Competition Rules ("Rules"), the Arizona Corporation Commission ("Commission") has already determined that "the Commission *shall* allow recovery of unmitigated Stranded Costs by Affected Utilities." A.A.C.

R14-2-1607 (emphasis added). The accompanying analysis of the Rule states that "the Rule does guarantee recovery of unmitigated Stranded Costs . . . ." *See* Decision No. 59943 at 47. This Rule was drafted by Staff and approved by the Commission after full opportunity for public comment by those desiring to deny "Affected Utilities" their rights to stranded cost recovery. Those parties who now oppose the recovery of such costs had every opportunity to appeal Decision No. 59943, but chose not to pursue such an appeal or even to seek reconsideration by the Commission of Decision No. 59943. In fact, several parties in this proceeding who now challenge the recovery of stranded costs have specifically intervened in the court appeals filed by "Affected Utilities" and have urged that the Rule be affirmed *en toto*.

Second, no party has alleged any changes in Arizona law, the regulatory policy of the Commission, or any new factual developments that would warrant a change in the Commission's regulation. Commission Staff's own recently obtained witness could cite no "changed circumstances" that would justify departing from the Commission's decision regarding stranded cost recovery. (10 Tr. 3302, *et seq.*)[1]

Third, any attempt to deny APS stranded cost recovery with respect to its regulatory assets and Palo Verde costs would represent an impermissible collateral attack on prior Commission orders.

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[1] As recent as September 30, 1997, the Director of the Utilities Division authored the Stranded Cost Working Group Report ("Report") to the Commission. In that Report, which was officially noticed herein, Commission Staff strongly supported recovery of Stranded Costs. Consider, for example, the following passages:

> The recovery of legitimate stranded costs is necessary to prevent cost shifting between customer classes, to treat utility investors fairly, and to promote efficient competition. Stranded cost recovery is mandated by the FERC in its Wholesale Competition Rules, was affirmed in the 1996 Economic Report of the President, and has been endorsed by all the states moving toward retail competition. (Report at 6)

Later in the Report, Staff concluded that:

> While some absorption by the Affected Utilities' investors would undoubtedly reduce the stranded cost burden for consumers to ultimately bear, *the Staff is unaware of any legal or regulatory basis for doing so*. (Report at 49, emphasis added)

Decision No. 59601 (April 24, 1996) approved the accelerated amortization and recovery of certain regulatory assets over an eight-year period commencing July 1, 1996. These assets were primarily cost deferrals from Palo Verde Units 2 and 3 that were recorded under Commission- approved accounting orders and regulatory assets to cover future income tax liabilities recorded in 1993 as a result of implementing FAS No. 109 with respect to deferred income taxes. This recovery was supported by Commission Staff, whose testimony referred to the Commission's "promise" that such amounts would be recovered. (Ex. APS-6). In addition, Commission Staff entered into a Settlement Agreement in 1994, which was approved by the Commission in Decision No. 58644 (June 1, 1994), providing for the *future* rate treatment of all three Palo Verde units. In relevant part, the Commission directed that "in subsequent rate cases, all three Palo Verde units shall likewise be included in rate base and their fair value shall be based upon the depreciated original cost value and reconstruction values, less the net prudence disallowance adjustment in the 1991 Settlement in the same manner as other APS generating facilities." Decision No. 58644 at 12.

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In light of the above, APS submits that no change regarding the Commission's previous determinations that APS shall be given the opportunity to fully recover its unmitigated stranded costs is either justified or lawful. As discussed hereinafter, to do so would constitute arbitrary regulatory opportunism of the worst sort.

The remainder of this Reply Brief will identify those specific areas, organized by subject matter (rather than by the Chief Hearing Officer's specific questions), with which APS takes particular exception. Failure to address a specific argument or contention raised in another party's initial brief does not indicate APS concurrence. Rather, it reflects the time constraints that forced APS to focus on only certain of the myriad issues raised by the thirty-five (35) witnesses in this proceeding.

II. FIVE MYTHS PROPAGATED BY STAFF AND CERTAIN INTERVENORS RELATIVE TO STRANDED COST RECOVERY

APS must again emphasize that, at least in its case, "stranded costs" do not represent some new category of costs for which the Commission must determine prudence, reasonableness or even the ultimate responsibility for their recovery. Each of these issues has already been decided by the Commission in prior APS rate proceedings, and more specifically, in two (2) previous rate agreements approved by the Commission.

Likewise, the generic issue of stranded cost recovery was thoroughly considered and resolved in favor of full recovery during the 1996 rulemaking proceeding. Virtually none of the parties now urging fundamental changes in the Rules indicated such a need during that proceeding, and indeed, some of them (e.g., the "Arizonans for Electric Choice" or "AEC") actively opposed even the slightest clarifying change to the Rules during every one of the various working group processes.

There have been absolutely no factual changes in circumstances that would warrant any change in that conclusion. 10 Tr. 3302 (K. Rose). Nevertheless, Staff and several intervenors have now insisted on propagating and perpetuating fanciful rationales for why less than a reasonable opportunity for full recovery of stranded costs is appropriate. These include:

<u>Myth Number 1</u>	There is legal precedent that would support the regulatory opportunism inherent in less than full recovery.
<u>Myth Number 2</u>	Stranded cost recovery is anticompetitive because it creates. a significant barrier to new market entrants.
<u>Myth Number 3</u>	Less than full stranded cost recovery will provide a needed additional incentive for stranded cost mitigation.
<u>Myth Number 4</u>	Utility investors have been previously compensated for the risk of stranded cost disallowances or, alternatively, will be adequately compensated by future sales of generation and other services at deregulated prices.
<u>Myth Number 5</u>	There are reasons of equity and fairness that support less than full recovery.

A. The "Legal Authority Supports Less Than Full Recovery" Myth

Not even the most enthusiastic adherent to this myth has claimed that there is any legal authority that could be interpreted as *prohibiting* this Commission from upholding its original Rules and allowing for full stranded cost recovery. They merely suggest that it may be possible for the Commission to renege on its prior commitments with legal impunity. Even if true, a regulatory policy

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based on what one is arguably able to "get away with" necessarily reduces the regulator to the lowest level of legally permissible behavior—hardly an auspicious start to the restructuring and reregulation of the electric industry. However, the legal authorities cited by Staff and others for this minimalist approach to the Commission's regulatory responsibilities do not support their conclusions.

For example, Staff correctly cites that two Superior Court judges have ruled that the Commission has the authority to implement retail electric competition and that one of these judges (Judge Dann) has found that the utility's CC&N does not represent a "contract" assuring the utility of continued monopoly as against over providers.[2] Staff Brief at 12. However, neither of these decisions found that the "Affected Utilities" were not entitled to full recovery of stranded costs.

Staff also cited *National Railroad Passenger Corporation v. Atchison, Topeka, and Santa Fe Ry. Co.*, 470 U.S. 451 (1985). Staff Brief at 14. That decision had nothing to do with stranded cost recovery or any other analogous issue. Moreover, the case was decided on the narrow grounds that the railroads' admittedly legitimate contracts were with Amtrak rather than the federal government and the fact that the legislation in question was federal legislation and thus not subject to the Constitutional prohibition against impairment of contract.

Finally, Staff attempts to dismiss the Arizona Supreme Court's clear endorsement of a regulatory "contract" in *Re Application of Trico Electric Cooperative, Inc. v. Senner*, 92 Ariz. 373, 377 P.2d 309 (1962) as "a metaphor to describe the nature of regulated monopoly."[3] However, *Trico* was not the first nor last reference to Arizona's legislatively created "contract" with regard to public service corporations. The *Trico* court was reiterating the regulatory contract language used eight years

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[2] Judge Campbell's two decisions (Staff's Brief provides only the first of these) are less clear. Although clearly finding that Tucson Electric Power ("TEP") had been granted a legal monopoly pursuant to its CC&N, he went on to rule that such monopoly could only be altered through compliance with A.R.S. § 40-252, a procedure yet to be followed by the Commission.

[3] " By the issuance of a certificate of convenience and necessity to a public service corporation, the State in effect *contracts* 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.* " 92 Ariz. at 380-381, 377 P.2d 309 (emphasis added). The language would appear to be describing much more than a simple metaphor.

earlier in *City of Tucson v. Polar Water Company*, 76 Ariz. 404, 409, 265 P.2d 777 (1954). By that earlier decision, the Supreme Court invited the legislature to expand the existing protections afforded the regulatory "contract" to include a restriction on competition with public service corporations from public power entities. The result, A.R.S. §9-516, has been thereafter construed broadly enough that public power entities themselves also enjoy the protection of a legislatively created "contract":

> The right [of the City of Mesa] to compete with the [Salt River Project Agricultural Improvement & Power] District in the disputed localities has been expressly denied by the legislature in its enactment of A.R.S. § 9-516, subd. A.
>
> . . .
>
> A large investment has been made in generating equipment and the various works necessary to supply power to consumers. The District by its investment has committed itself to a public utility undertaking plainly accepting the grant of the state to engage in that business. *By such conduct a property right has been created which is protected by the [Arizona] Constitution, Art. 2, § 25 forbidding the enactment of any law impairing the obligation of contract.* [emphasis added.]

City of Mesa v. Salt River Project Agr. Imp. & P. Dist., 92 Ariz. 91, 99-100 (1963).

Staff witness Rose acknowledged the existence of a regulatory "compact" but now attempts to downplay its significance. 10 Tr. 3275 (K. Rose). However, Dr. Rose was not always so reserved on this subject:

> Utilities have historically had an obligation to make investments necessary to provide service on demand. The granting of a certificate to serve, along with its accompanying obligations and reciprocities and intermediations, as embodied in statues and case law, constitute the "regulatory compact."
>
> . . .
>
> The alternative [to stranded cost recovery] is to have utility investors bear the cost of the plant. But requiring utility investors to absorb the prudently incurred costs which they were legally required to incur, without compensating them for the risk of such cost absorption, is a regulatory inconsistency that could be termed confiscatory.

Ex. APS-7 (quotations from K. Rose publications).

The AEC claims that *Appeal of Public Service Co. of New Hampshire*, 676 A.2d 101 (N.H. 1996) supports its position on stranded costs and reflects a "regulatory scheme and case law" that "are very similar to Arizona's." (AEC Brief at 26). APS, however, is unaware of any New Hampshire

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cases remotely similar to *Trico* or *City of Mesa.* In any event, the New Hampshire decision provides no basis for stranded cost disallowance. The New Hampshire Supreme Court specifically held:

> We emphasize that our decision today should not be read as expressing a point of view either on the desirability of retail competition among electric utilities as a matter of policy or on the recoverability of "stranded costs" in the event competition is introduced.

Id. at 109. Moreover, the fact that New Hampshire's restructuring program has been presently stayed by virtue of a federal court injunction directly related to the stranded cost issue should hardly inspire the Commission with any great confidence in the "you can get away with it" defense urged by Staff and certain intervenors herein. *Public Service Co. of New Hampshire v. Patch, et al.*, 962 F. Supp. 222 (D. N.H. 1997).

APS would draw the Commission's attention to one of the only decisions by a state supreme court actually addressing "stranded cost" recovery. In *Hudson Light & Power Department v. Department of Public Utilities*, 688 N.E. 2d 1337 (Mass. 1997), the Massachusetts Supreme Judicial Court reversed a commission decision that denied appropriate stranded cost recovery. It held that: "Permitting utilities to recover their prudently incurred stranded costs promotes fair and effective competition in the electric industry." *Id.* at 1346.

For APS, the "regulatory compact" is more than an abstract legal concept. As discussed previously, in Decision No. 59601 the Commission agreed to the full collection of APS' regulatory assets by 2004. In Decision No. 58644, there was a similar commitment concerning the future rate making treatment of Palo Verde—a commitment for which APS "paid" by agreeing to over $400 million in Palo Verde write-offs. Ex. APS-9 (J. Davis Rebuttal Testimony) at 7. The Commission is obligated to keep its settlement agreements. *U S WEST Comm. v. Arizona Corp. Comm'n*, 185 Ariz. 277, 915 P.2d 1232 (Ct. App. 1996). Therefore, at a minimum the Commission must permit full recovery of all APS regulatory assets and of Palo Verde-related stranded costs.

B. The "Barrier to Competition" Myth

This is really a "Johnny Come Lately" argument to the whole stranded cost issue. Staff did

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not raise or even mention any such competitive "concern" during the long 1996 rulemaking process. Even to this day, Staff has never performed any analysis showing that stranded cost recovery would have even the slightest anti-competitive impact. 10 Tr. 3300 (K. Rose). In fact, Staff's economic analysis of the Rules, which was adopted *verbatim* in Decision No. 59943, waxed eloquently on the unqualifiedly pro-competition nature of the Rules. To APS' knowledge, no other state or federal commission has found or even alleged that full stranded cost recovery will be, in any sense, *per se* anticompetitive.

Two of the likely new competitors, Enron and PG&E Energy Services, have not claimed any such market barrier. Neither Enron, nor PG&E, nor APS, nor any of the other 250 plus other registered generation suppliers in California apparently believe that California's stranded cost recovery program has somehow retarded their enthusiastic entrance into that state's electric market.

RUCO's expert witness in these proceedings, Dr. Rosen, clearly debunked the "barrier" myth in the following exchanges:[4]

Q. Perhaps I didn't make myself sufficiently clear in the last question, Dr. Rosen. I'm not talking now about who pays and who doesn't; I'm talking about whether or not the ratepayers absorb more than their share of stranded costs, so to speak.

Let's assume that all ratepayers pay, for purposes of my question, or all customers on the system, through a wires charge that you don't have a problem with self-generation. Under that assumption, does the true-up then perform a role in contributing to a level playing field result?

A. No. It is completely irrelevant.

Q. Why is it irrelevant?

A. Two different issues. As long as there's a nonbypassable wires charge which you have hypothesized, it doesn't matter whether the charge is too high, too low, or whatever. It could be completely unjust if it's a level playing field, doesn't matter what the size is. It doesn't affect alternative competition between utilities and suppliers. They're all faced with the exact same charge if the customer is using the same amount of electricity.

Again, I never quite understand why some people have said that, you know,

---

[4] Hopefully the Attorney General, another belated convert to the "barrier" myth, does not regard Dr. Rosen as an APS "shill." Attorney General Brief at 25.

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> nonbypassable charge creates a competition issue. The whole point of being nonbypassable, that term is used precisely to indicate that it creates a level playing field by definition.
>
> . . .
>
> Q. Let me try approaching this subject a different way so that Mr. Rudibaugh doesn't give me the curtain call signal too early.
>
> From your perspective, does use of the net revenues lost approach contain any inherent potential disadvantages for new entrants?
>
> A. No. I don't see where it's related to this issue of competitive advantage or disadvantage. I don't get it.
>
> Q. And again, just for my edification, the reason you don't see any relationship is why?
>
> A. Because however the stranded cost recovery charge is determined, however it's set, it's competitively neutral, namely, nonbypassable wires charge. The methodology for computing stranded costs are irrelevant to the issue as to whether new market entrants or new suppliers or term suppliers have any competitive advantage or disadvantage relative to the incumbent utility. It's just like two separate issues. They don't—there's no conflict because they don't meet.
>
> . . .
>
> Q. Bear with me for a moment because I may be plowing old ground.
>
> As I understood the Staff's testimony in this case, through Dr. Rose, Staff expressed a concern that any recovery of stranded costs may impact negatively the development of a competitive retain generation market, and I took it from one of the responses, or several of the responses you gave today, that you do not share that view; is that correct?
>
> A. That's correct. I disagreed with Dr. Rose on that point. In fact, I think I discussed that some in my rebuttal testimony. But I just don't understand it.
>
> Q. Where do you think he's missing the boat?
>
> A. I point out in my rebuttal testimony that he seems to have made an error in one of his examples illustrating the point. Again, I thought, why, I can't tell you. I really am perplexed. I've seen the argument come up in other states as well, and I still don't get it, for what that's worth.

6 Tr. 1913-1916, 1921-1922 (R. Rosen).

Mr. Nelson, another of the "barrier" proponents (however, apparently only when testifying with his "Electric Competition Coalition" hat on since Enron, Mr. Nelson's other client, had not expressed such concerns), appeared to contradict himself by agreeing that analogous "wires" charges in the form of distribution rates would not be a barrier to entry. *See* 13 Tr. 4211-4212. If it doesn't make any difference if distribution rates are higher in one area than another (presumably because they are the same for all potential competitors), how could that same "wires" charge become a barrier to entry simply because some portion of that distribution rate is now labeled as a stranded cost transition charge?

Another variant of the "barrier" myth is the assertion that stranded cost recovery somehow subsidizes the incumbent utilities' marginal capital or variable operating costs. This either reflects a misunderstanding of how stranded cost recovery would work under any of the methods proposed herein, including auction and divestiture, or a deliberate misstatement of the "Affected Utilities'" proposals.

Ironically, the failure to accord full stranded cost recovery, while crippling the "Affected Utilities," will in the end do nothing to promote competition by creating what new entrants hope will be an artificially high "contestable" price of generation. This is because the real barrier to new entrants actually capturing customers in Arizona is not stranded cost recovery but the low variable generating costs of the incumbent:

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> Q. I believe, Pages 11 and 12, you -- well, let's start with Page 11 in your direct testimony. You discuss barriers to entry and exit. What is your opinion regarding the level of the stranded cost recovery as being a barrier to entry for competitors?
>
> A. I think the level of stranded cost recovery has no effect on entry or exit, or should have no effect on entry and exit.
>
> Q. Why shouldn't it?
>
> A. Competition occurs on the basis of incremental costs. If I can sell to customers at an incremental cost to me of two cents, I can compete favorably with you if you have an incremental cost of three cents. Whether or not I'm recovering some other such costs is irrelevant in that calculus.
>
> Q. But it's true the size of the total affects the ability to market the product; isn't that correct?
>
> A. I do not believe that's correct. Let's take a hypothetical. Let's assume that all customers in the state have to pay four cents a kilowatt hour towards stranded costs. Okay, if I have an incremental cost of two cents, and you have an incremental cost of three cents, I'll still beat you because every customer has to pay four cents anyway.

My six cents will beat your seven cents, so I'm going to get the business because my incremental costs are lower than yours.

So leaving the four cent stranded cost in place does not disable competition, does not harm competitors from competing with each other, and going forward, therefore there's not a disabling of the process, if we place it with that hypothetical.

The second hypothetical where stranded cost recovery was two cents for every customer, I would still win because my four cent rate would beat your five cent rate. As long as everyone is paying the same stranded cost charges customers are free to compete on the basis of incremental costs, and those firms that are most efficient will prevail in the market, and the firms that are not efficient will fall by the wayside.

Q. Let me assume that APS has publicized the generation of the electric bill is very small, that's only 10 percent or some figure like that, and if you could purchase competitive generation, you might only save 10 percent or let's say it's 30 percent, you save 10 percent of that 30 percent, there's only three cents savings out of your total bill.

If you use my example, if that's true, and the stranded costs component pushes up the amount of the headroom in which to competitively sell generation, isn't that a factor?

A. I don't understand your hypothetical. I don't see what you mean by pushing up the headroom. The differential between your costs and my costs will still be the same. In my case I can sell it at two cents, your costs, you have to sell at three cents. The difference is the cent. Whether one cent is on top of a stranded cost recovery of two cents or four cents or six cents is irrelevant. I can still save a cent by going --

Q. Let me compete the example.

A. Can I complete my answer first?

Q. Let me complete the example, if I may. The headroom is to the standard offer. That's the headroom. That's the top part of the example.

A. What standard offer?

Q. From the utility. In other words, they can either stay with the utility at this fixed rate, or they can come over to the competitor, and they only have that certain margin in which to compete in the generation value because the rest of the differential is taken up with the distribution charges and the standard cost rate.

A. Then we're back to exactly what my example was. As long as everyone has to pay the stranded costs, whatever amount they are, all competitors at the margin can compete to serve the remaining product at their respective costs, and the lowest cost provider should prevail in that competition.

9 Tr. at 2913-2916 (J. Landon).

. . .

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> Q. So would you conclude that in the hypothetical used by Dr. Rosenberg, the new market entrants' problem is the low variable cost of the incumbent, not the CTC?
>
> A. Yes.

9 Tr. at 2951 (J. Landon).

C. The "Incentive to Mitigate" Myth

Many of the 'incentive to mitigate" mythologists are simply old fashioned "sharing" proponents who have discovered a new angle. They propose percentage disallowances far in excess of any remotely conceivable ability to mitigate and suggest less than full recovery in situations where significant future mitigation is impossible, such as in the case of regulatory assets, nuclear fuel disposal, and even in the case of a forced divestiture of assets resulting in unmitigatable losses to the utility. None of these witnesses has offered an iota of anecdotal evidence that sufficient mitigation opportunities exist to "cover" their arbitrary disallowance percentages. However, even if the percentage disallowance were a reasonable guess as to what level of "gross" stranded costs might be mitigatable, it would not be the use of the percentage recovery mechanism itself that would create any incentive to actually mitigate costs. Whether the Commission allows full stranded cost recovery, 80% stranded cost recovery, or 0% stranded cost recovery, the utility will have exactly the same incentive to mitigate stranded costs so long as it is allowed to retain all or a meaningful portion of the savings from such mitigation rather than flowing them back to customers in the form of further reductions in rates or otherwise recoverable stranded costs.

> Q. Another theory which has, of course, been forwarded at my last count, I think there are seven witnesses who have recommended some sort of sharing in which shareholders would be forced to absorb anywhere from 25 to 75 percent of stranded costs. And as I say, I think it's been put forward by about seven different witnesses. We can call them the magnificent seven.
>
> And their theory seems to be that this is necessary in order to put utilities at risk so that they will accomplish mitigation which in turn then will result in some efficiency.
>
> Do you find any merit with that approach?
>
> A. I find a very slight amount of merit in it. And the slight amount of merit I find is as follows: That if you say I'm going to give you what you spend no matter what happens,

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> obviously, you have no incentive to mitigate.
>
> But the point, and I think it is their point, that if I take half your income away, that will cause you to work harder, does not strike me as an obvious proposition at all. If I get to keep 100 percent or 50 percent or 25 percent or whatever it is of any incremental savings that I save, then it's my benefit to make those savings, whether I've gotten all of my stranded costs or half of my stranded costs or 35 percent of my stranded costs or 85 percent.

8 Tr. at 2572-2573 (W. Heironymus). *See also* 13 Tr. at 4094-4097 (K. Higgins).

D. The "Investors Have Been or Will Be Fairly Compensated Without Stranded Cost Recovery" Myth

In the various opening briefs, the parties have all but abandoned the contention of some of their witnesses that Affected Utilities may have already been explicitly compensated for the risk of significant stranded cost disallowances through higher rates of return. This is presumably because there is not the barest shred of evidence to support such a contention. Instead, parties now claim that irrespective of whether the Commission ever explicitly compensated the utilities for the risk of stranded cost disallowance through higher returns, investors have always assumed the risk of what is called, in a classic understatement, "regulatory change."

Within some very narrow parameters, the above contention may be supportable. However, we are not talking about a change from historical to projected test periods, the implementation or abolishment of this or that rate adjustment clause, or even a switch from a prudent investment standard to a "used and useful" standard. We are instead faced with an entirely new regulatory paradigm from that followed in the over eight decades of Arizona's existence. For the first time, reasonable and prudent costs already review by the Commission and allowed in rates are at risk of a subsequent, deliberate and systematic disallowance by this Commission. For the first time, regulatory assets, which are themselves essentially regulatory promises to pay in the future for past costs incurred by utilities and for past benefits conferred on ratepayers, *see* 9 Tr. 2957-58 (K. Kissenger), have been placed at risk for similar *ex post facto* disallowance. To characterize this as a mere "regulatory change" is like calling the French Revolution a "change of administrations" in Paris.

Other parties acknowledge the sweeping nature of presently contemplated industry

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restructuring but claim it was somehow foreseeable decades in advance. They point to PURPA even though that law expressly prohibited retail competition and treated incumbent utilities as monopolies. They point to the EP Act of 1992 even though the Act expressly prohibited FERC from requiring retail transmission. They ignore the fact that this Commission's orders implementing the relevant portions of PURPA do not even mention competition and authorize only wholesale transactions by QFs and IPPs. *See* Decision Nos. 51861 (February 19, 1982) and 52345 (July 27, 1981). They gloss over the Commission's adoption of integrated resource ("IRP") regulations in 1989 (A.A.C. R14-2-701, *et. seq.*)—regulations premised on the continuation for the foreseeable future of regulated monopoly in the provision of electric generation and which even define the term "utility" as: "<u>the</u> [singular] entity providing electric service to the public." A.A.C. R14-2-701 (42) (emphasis added). As late as 1995, APS and other Arizona utilities subject to IRP were required by the Commission to file resource plans on the basis of regulated monopoly. Thus, the claim of some that retail competition was clearly predictable does not match the facts. Historical revisionism can not excuse what is no more than a call for regulatory opportunism, plain and simple.

The "future profits will offset disallowed stranded costs" argument is even more specious. *By their very definition*, "stranded costs" are those costs that can not be recovered by future sales of electric generation in a competitive market. The "wires" business of the "Affected Utilities" will presumably be regulated on a more or less traditional basis for the foreseeable future, so there is no potential there for the sort of future supernormal profits that would offset the certainty of the disallowed stranded costs of today. This would leave only the same non-electric lines of business presently available to "Affected Utilities." Proponents of this line of reasoning have provided no legal authority for using the wholly speculative profits from some hypothetical new line of business to offset costs legitimately incurred by "Affected Utilities" prior to the Rules passage to provide electric service in accordance with their responsibilities under law. Furthermore, there is absolutely no common sense basis for believing that "Affected Utilities" could earn in *any* competitive line of business the amount of supernormal profits necessary to recover, in the case of APS, some $1 billion in as of yet unrecovered regulatory assets and as much as another $500 million in above market power supply costs.

E. The " 'Sharing' is Equitable" Myth

This is perhaps the hardest argument for the Company to understand. All of what would be strandable costs are already being collected in what the Commission has expressly found to be "just and reasonable" rates. In very large part, they represent costs that the Commission has expressly promised the Company would be given a reasonable opportunity for full recovery. Yet some parties now argue, in the name of some peculiar definition of "fairness," that recovery of these same costs should be partially disallowed because of a restructuring process which APS neither initiated nor requested.

Q. I assume you've read much of the testimony in this proceeding.

A. That's correct.

Q. And you recognize there are various proposals as far as sharing of stranded costs?

A. Yes, that's correct.

Q. Some witnesses have indicated, for example, that they would have—and let's take for this hypothetical that they've proposed a 50/50 sharing, and that they've further indicated that that sharing may be modified based on the financial condition of the individual utility affected. All right?

A. I understand the assumptions, yes.

Q. Now, and assume the Commission adopted that and as a result you had some utilities with 50/50 sharing, some with 75/25, some 100/0. How would you respond to that? Is there something inherently wrong with that, or does that sound like a fair resolution?

A. I don't think it sounds like a fair resolution at all if the utility is due the money, if it is the utility's money.

Take the example of a regulatory asset, because that's a clean example. Regulatory assets arise because the Commission required the company to defer collection of monies. Those monies are owed the company, and the company has a right to recover those assets.

The idea that we can take 50 percent of them away from the company is a taking of whatever amount of money that amounts to. It isn't an okay taking because 50/50 sounds fair. It's like saying, I am come in your house and take your silver, and if I'm caught, I may be required to return only half of it. *Theft is not fair because it's shared*

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between the thief and the victim.

9 Tr. 2843-44 (J. Landon) (emphasis added).

III. STRANDED COSTS ATTRIBUTABLE TO POWER SUPPLY ARE PROPERLY MEASURED BY THE DIFFERENCE BETWEEN THE REGULATED COST OF SUCH POWER SUPPLY AND ITS MARKET VALUE

This is essentially the same "wholesale v. retail" price debate discussed in the Company's Initial Brief. Indeed, Dr. Heironymus clearly explained why the Company's position was correct in the testimony quoted in the Company's Initial Brief. However, as also noted in that Initial Brief, the real issue is whether to use the market price of generation or the market price of sold and delivered electric service. There is and likely will be no recognized market price for delivered retail electric service. Even if there were, one would have to be able to first determine that price and then "back out" the cost (plus markup) attributable to all the other services included in the final end product we call electric service. Some, such as distribution and transmission costs, may be publicly available because they will remain regulated services. Others, such as retailing and marketing costs, the costs of credit and finance, billing, premiums commanded for "green power," etc., almost certainly will not.

If one were to think of this as a mathematical equation in which G equals the market price of generation and X equals the summation of the prices (some regulated and some not) of the other services encompassed in the "all in" price of electric service, then the retail price of electric service, which we will call Y, would be represented by the equation $G + X = Y$. Although we can determine G from widely available and reliable market indices, the "retail price" proponents would instead have regulators administratively determine G by first trying to find what X and Y are and then subtracting the former from the latter. Because both Y and, for the most part, X will themselves have to be administratively determined, we now have to make two administrative guesses at market prices in an effort to administratively determine exactly that value of electric generation for which we had objective market data to begin with, namely, G. Worse yet, some witnesses simply wish to ignore X altogether. In reality, the "retail price" argument is simply an excuse to ignore actual market prices for the commodity in question, i.e., generation, and substitute inflated and necessarily administratively-determined "retail prices" so as to disallow legitimate stranded costs.

IV. THE COMMISSION SHOULD ADOPT THE SHORTEST REASONABLE TIME FRAME FOR THE CALCULATION PERIOD FOR STRANDED COSTS.

Extending the period for calculating stranded costs 20 or more years into the future, as some parties to this proceeding suggest, is inappropriate, impractical and unnecessary. First, every party to this proceeding agreed that the longer the calculation period, the more forecasting error is introduced into the equation. Second, rather than effect a rapid transition to competition, such a long-term calculation seeks to perpetuate regulation (at least for the Affected Utilities). Third, present value discounting is a front-loaded process that dramatically reduces the significance of most financial occurrences 10 or 20 years from now. Finally, and most egregiously, RUCO's proposal to use a 20-plus year calculation period (adopting their stranded cost estimates) seeks to asymmetrically shift risk onto the Affected Utility. Specifically, RUCO claims that

> Once ratepayers have paid for the [stranded costs] of these power plants, it would be unfair to deny them the longer-run benefits of these plants when the cost of their output is lower than market priced alternatives.

RUCO's Initial Brief at 21. Under competition, however, the Affected Utility bears the risk of its costs exceeding market price—the ratepayers do not share this risk. Thus, merely assuming that generation assets will be profitable 15 years from now and then awarding ratepayers this supposed "profit" today, without any corresponding exposure of ratepayers to the risk that the hypothesized future profits will not materialize, is wholly inequitable.

V. THE COMMISSION MUST DISREGARD RUCO'S "ESTIMATES" OF NEGATIVE STRANDED COSTS.

RUCO argues in its Initial Brief that APS has no stranded costs, or will have so-called "negative" stranded costs, if a 15 to 30 year forecasting period is utilized. RUCO's Initial Brief at 16-18. Such an argument in this proceeding is entirely inappropriate. *See* Stranded Cost Proc. Conf. Tr. at 47 (counsel for RUCO acknowledging that "estimates" were to illustrate a methodology and were

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not reliable estimates for any Affected Utility); Ex. RUCO-1 (R. Rosen Direct Testimony) at 51 (acknowledging that calculations are for "illustrative" purposes only). Moreover, RUCO's "estimates" are fundamentally flawed.

Dr. Heironymus identified the numerous fatal assumptions in RUCO's "illustrative" calculations. Ex. APS-3 (W. Heironymus Rebuttal Testimony) at 27-31. For example, the estimates assume massive amounts of "phantom generation" from existing resources—that is, APS' generation must increase 67% (from 18 TWh to 30 TWh) by 2020 without adding new generation plant and in spite of retiring existing plant. *Id.* at 28. The estimates further assume that the regulated cost of generation will decline by 2 to 3 percent in real terms over the life cycle of an asset, but that market price will rise in real terms throughout the calculation period. *Id.* at 29. RUCO's witness then used an assumed retail price in the stranded cost calculations without including retailing and other costs subsumed in the final retail price, thus "vastly understating" stranded costs. *Id.* at 27. Tellingly, no party to this proceeding challenged Dr. Heironymus' analysis of the flaws inherent in RUCO's estimates. *See* 8 Tr. 2564-2697. RUCO's "estimates" must be entirely disregarded.

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VI. THE COMMISSION CANNOT COMPEL AFFECTED UTILITIES TO DIVEST GENERATION ASSETS.

Those parties hawking divestiture most forcefully in this proceeding are, not surprisingly, either the parties with a recognized self-interest in obtaining maximum competitive advantage or those least familiar with regulated utilities and with regulation.[5] However, this issue is far from being one

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[5] For example, potential bidders PG&E and Enron support "voluntary" or "incentive" divestiture—i.e., divest or receive no stranded costs. Initial Brief of PG&E at 8; Initial Brief on Behalf of ECC and Enron at 7. Also, Citizens—saddled with a 1996 purchased-power contract with APS that it now wants out of, and not possessing any auctionable generation assets itself—proposes "voluntary" auction and divestiture, being sure to include purchased power contracts in the assets to be auctioned. Then, to ensure that Citizens' contract would be among the assets auctioned off under its proposal, Citizens adds a requirement that if APS wants *any* stranded cost recovery, *it must* auction *all* of its resources. Citizens, however, has not proposed divestiture in the state in which it owns generation assets. 1 Tr. 198 (S. Breen).

Certain other proponents of divestiture, such as the Department of Defense or the Arizona Consumers' Council, are clearly unaware of the practical problems, time, and expense such a divestiture would entail. In contrast, RUCO criticized divestiture, *see* RUCO's Initial Brief at 7-9, and Staff's economist testified to the impracticability of of first impression with the Commission. In Decision No. 59943, the Commission considered and rejected the divestiture option:

> [T]he Commission's regulatory authority to require divestiture of utility assets may be questioned and result in a protracted legal dispute. Further, utilities, utility shareholders, and utility debt holders may strongly resist divestiture. Divestiture could be costly due to expensive debt re-financing. In addition, inefficiencies could result from the loss of traditional coordination of generation, transmission, and distribution services.
>
> The restructuring policy proposed is preferred to [divestiture] because it: minimizes administrative complexity; ... is relatively flexible so that policy could be adjusted mid-course; ... minimizes utility organizational disruption; ... and minimizes public confusion.

Id. at 63.

No party has pointed to any new circumstances since the Commission adopted Decision No. 59943 that would support changing the Commission's position on divestiture now. No party to this proceeding has provided a persuasive practical or economic basis to support divestiture. Indeed, Staff concluded as late as September 30, 1997 that auction and divestiture was not the preferred approach to calculating stranded costs. *See* Stranded Cost Working Group Report at 24-25, 27-28 (Sep. 30, 1997). And no party has offered *any* legal argument that the Commission has the authority to order divestiture. Compelled or coerced divestiture of generation assets is still unwise, uneconomic, and unlawful.

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A. From a Policy Standpoint, Compelled or Coerced Divestiture is Both Unwise and Uneconomic.

Requiring divestiture to value stranded costs is "a case of the tail wagging the dog." Ex. APS-3 (W. Heironymus Rebuttal Testimony). The stranded cost valuation methodology adopted in this proceeding must not dictate the market structure for Arizona utilities. *Id.* Moreover, although a number of parties in this proceeding point to "conceptual" benefits of divestiture, these parties ignore the practical barriers that militate against compelled divestiture.

First, for example, a compelled auction and divestiture process will not be developed and

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the auction and divestiture approach, *see* 10 Tr. 3128-31 (K. Rose).

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concluded overnight.[6] There will be legal challenges that must be resolved prior to moving forward with any sale. Divestiture plans or a divestiture rulemaking proceeding must be proposed and resolved by the Commission during the busiest period in the restructuring process. Auctions must be conducted over time to avoid distorting valuations by the temporary oversupply created if all plants and assets are sold at once. *See* Ex. APS-4 (J. Landon Rebuttal Testimony) at 27.

Second, the market for generation assets is undeveloped; there is certainly a risk that, rather than premium prices touted by divestiture proponents, compelled auctions will net "fire sale" or below-book prices, resulting in increased stranded costs (with no mitigation alternatives). *See, e.g.*, 1 Tr. 235 (S. Breen). Pinning all the Commission's hopes on the results of a few out-of-state generation plant sales, made under circumstances not present in Arizona, is not prudent policy-making. For example, Mr. Bayless testified how prior above-book sales of out-of-state plants may be illusory when compared to Arizona facilities:

> The thing I do not know, which is critical to all of this, is the fuel contracts at those plants. A one-cent decrease in our fuel price at a plant is going to affect the net present value of that plant by close to a billion dollars. So a plant with a one-cent contract is a far different animal than a plant with a two-cent contract....
>
> The other thing that will affect the plant sales price is the perceived electricity price in [the] region. You can't get as much gas in New England as you can here. The pipeline capacity just isn't there.... If we were going to get four times book, believe me, the "for sale" sign would be hung from the top of the plant. But I don't believe that would be the case.

5 Tr. 1529 (C. Bayless).

Third, transaction costs may significantly affect the outcome of any sale. Complex power contracts, labor contracts, mortgage covenants, and debt obligations tied to the asset must be transferred, unwound or otherwise resolved. For jointly-owned facilities or investor-owned utilities, consents must be negotiated with shareholders, partners and creditors. *See, e.g*, 6 Tr. 2055 (W. Edwards). Further, if divestiture is compelled, either directly or indirectly, the bargaining power of

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6 TEP President Charles Bayless testified that a divestiture approach would take at least one year, and probably longer. 5 Tr. 1531 (C. Bayless).

the "Affected Utility" seeking to resolve these issues is completely undercut, a difficulty further compounded by the complicated sale/leaseback financing for several APS generating units. *See* 7 Tr. 3743 (J. Davis). The result: the net proceeds from the resulting sale are lower than if divestiture was voluntarily pursued for legitimate reasons.

Fourth, and of particular significance in Arizona, the vast majority of parties agree that nuclear assets cannot be reasonably divested. *See, e.g,* 1 Tr. 99 (S. Breen); 3 Tr. 838-39 (M. Petrochko) (noting that no bids could be solicited for Maine nuclear plants); 4 Tr. 1258 (D. Ogelesby). Any sale of even an interest in a nuclear facility will be subject to extensive Nuclear Regulatory Commission oversight and control. Moreover, APS holds the operator's license for Palo Verde, which would be even more difficult to divest than an ownership interest.

Fifth, there are compelling economic reasons to reject divestiture. Horizontal market power in a given region may increase depending on what entity purchases the asset. *See* 1 Tr. 196 (S. Breen). Economies resulting from integrating generation and distribution are precluded. Indeed, the Economic Impact Statement adopted by the Commission recognized this economic inefficiency when rejecting divesture. Decision No. 56693 at 63.

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B. Compelled Divestiture is Unlawful.

Although several parties to this proceeding purport to identify "conceptual" benefits of divestiture, they fundamentally fail to recognize that the Commission cannot lawfully compel (or coerce) divestiture of generation assets.

1. <u>The Commission Lacks the Authority to Order Divestiture.</u>

In addition to the Commission orders recognizing the lack of authority which were cited in APS' Initial Brief,[7] courts have rejected the argument that a commission can use its power of regulatory oversight to compel divestiture of a utility's assets. *Public Utils. Comm'n v. Home Light*

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[7] *Re Elec. Ind. Restructuring* 163 P.U.R.4th 96, at n.31 (Mass. D.P.U. 1995); *Carmel Mtn. Ranch v. San Diego Gas & Elec. Co.*, 1988 Cal. P.U.C. LEXIS 67 at *14-15 (Mar. 9, 1988). *See also Re Arizona Corp. Comm'n*, P.U.R. 1919E, at 566 (holding that Arizona Corporation Commission lacked the authority to compel a water company to acquire the assets of another water company).

& Power Co., 428 P.2d 928, 935 (Colo. 1967). In *Home Light & Power*, certificated and non-certificated electric utilities—all subject to commission jurisdiction—were encroaching on each other. The Colorado PUC's solution was to order some of the utilities to sell lines and facilities to the other companies. *Id.* at 931. The Colorado Supreme Court rejected this abuse of power out of hand: "To order the sale of facilities would constitute a taking of the property without just compensation . . ." *Id.* at 935. The court concluded that if the commission found a sale price to be unreasonable, it could refuse approval, but the commission could not order a sale or fix the sale price itself. *Id.*

2. The Commission Cannot Exercise the Power of Eminent Domain to Compel Divestiture.

The unconstitutional taking referred to in the *Home Light & Power* opinion—and the compelled divestiture at issue here—unquestionably involves the attempted exercise of the power of eminent domain. *See, e.g., Hawaiian Housing Auth. v. Midkiff*, 467 U.S. 229, 241-42 (1984). In *Midkiff*, the Hawaii legislature, invoking its power of eminent domain, enacted a statute that allowed the state to acquire property from landowners of large estates and resell the property to private citizens in smaller, residential lots.[8] *Id.* If the Commission were to order an affected utility to sell its property *directly* to a private purchaser, the same "eminent domain" power analyzed in *Midkiff* necessarily results. *See id.* The Commission cannot effect a physical taking of a utility's property by removing the "middleman" and calling the physical confiscation "regulation."

Unlike the legislature in *Midkiff*, however, the Commission lacks the eminent domain authority to order such a property sale. *See City of Phoenix v. Donofrio*, 99 Ariz. 130, 133-35, 407 P.2d 91, 92-94 (1965); *GTE Northwest v. Public Util. Comm'n*, 900 P.2d 495, 498-501 (Ore. 1995). In *Donofrio*, the Arizona Supreme Court held that the legislature possessed the power of eminent domain, and that

[8] In *Midkiff*, the petitioner argued that a resale to private parties did not satisfy the "public use" requirement under the Fifth Amendment. Although the Court in *Midkiff* concluded that "public use" was satisfied because the legislature desired to mitigate the oligopoly created by large estate holders, no "public use" results from compelled divestiture of generation assets to private parties merely to effect a market valuation of private property. This issue need not be reached, however, as the Commission lacks the eminent domain authority which is a necessary precursor to this analysis.

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political subdivisions of the state could only exercise eminent domain authority for specific, legislatively-delegated purposes. 99 Ariz. at 134, 407 P.2d at 93-94. In *GTE Northwest*, the Oregon Supreme Court invalidated the state utility commission's attempt to exercise eminent domain authority because the legislature had not expressly delegated such authority to the commission. 900 P.2d at 498-501.

Similarly, in this case, the Commission possesses no implied power. *Commercial Life Ins. Co. v. Wright*, 64 Ariz. 129, 139, 166 P.2d 943, 949 (1948). The Commission lacks the express legislative authority to compel the physical divestiture of a utility's property. For example, the Commission has no authority to compel divestiture under the general eminent domain statute. *See* A.R.S. § 12-1111; *City of Mesa v. Smith Co.*, 169 Ariz. 42, 816 P.2d 939 (Ct. App. 1991) (permitting condemnation of "buildings and grounds" only for use as administrative facilities for city). No authority to force divestiture can reasonably be inferred from the Commission's legislatively-delegated power to order improvements or modifications to existing utility plant. *See* A.R.S. § 40-331. Nor can authority be found in the Commission's power to order *joint* use of facilities. *See* A.R.S. § 40-332. When the condemning entity is without authority to exercise eminent domain, the question of compensation for the taking is irrelevant. *GTE Northwest*, 900 P.2d at 498.

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3. Divestiture is an Equitable Remedy Vested in the Judicial Branch, Not the Commission.

Divestiture is a judicial *remedy*; it is not a tool for regulation (or deregulation) by the Commission. The United States Supreme Court has repeatedly stated that the purpose of divestiture is "remedial and not punitive."[9] *See, e.g., United States v. E. I. Du Pont de Nemours & Co.*, 366 U.S. 316, 349 (1961) (citing cases). Courts also recognize that divestiture, even in the context of an

[9] For example, the so-called *Schine Theaters* three-part rationale for divestiture speaks clearly and loudly in remedial terms: (1) divestiture puts an end to a statutory "violation"; (2) it deprives "violators" of the benefits of their "conspiracy"; and (3) it "renders impotent" monopoly power "violations" of the antitrust laws. *Schine Chain Theaters v. United States*, 334 U.S. 110, 128-29 (1948), *overruled on other grounds by Copperweld Corp. v. Independence Tube Corp.*, 467 U.S. 752 (1984). Clearly, these rationales are wholly inapplicable in the valuation context presented in this proceeding.

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antitrust case, is a "drastic" remedy that is not appropriate when other, less drastic alternatives will remedy a *violation* of law. *See, e.g., id.* (emphasis added). Apart from the fact that there is no "violation" to be "remedied" in this proceeding, the Commission is not vested with the broad equitable powers of the judicial branch such that the Commission could issue a divestiture order. *See Commercial Life Ins. Co.*, 64 Ariz. at 139, 166 P.2d at 949 (holding that the Commission has no implied powers); A.R.S. § 40-422 (requiring the Commission to apply to the Superior Court for equitable remedy).

Moreover, other less drastic methods[10] of valuing generation assets have been presented to the Commission. Indeed, the availability of less drastic methods is all the more significant because (1) divestiture will not obtain a valuation of all generation assets (i.e., nuclear facilities, regulatory assets, above-market power contracts, must-run units, etc.), *see, e.g.,* 4 Tr. 1258 (D. Ogelesby), and (2) several parties assert that an administrative valuation is necessary in any event to enable the Commission to approve, or allow it to reject, any market-based sale, *see* RUCO's Initial Brief at 7-8.

C. Coerced Divestiture is Equally Unlawful.

The Commission cannot condition recovery of stranded costs (to which APS is entitled) on the divestiture of APS' generation assets. *See Dolan v. City of Tigard*, 512 U.S. 374, 385 (1994) (holding that doctrine of unconstitutional conditions precludes government from requiring person to surrender the right to receive compensation for a state taking to obtain a discretionary benefit from the state); *Davis v. Hale*, 96 Ariz. 219, 225, 393 P.2d 912, 916 (1964) (holding that a city cannot "do indirectly what it could not do directly"). Several parties to this proceeding erroneously suggest that, if the Commission has concerns over its authority to compel divestiture, all it need do to finesse around this lack of authority is coerce the Affected Utilities to divest by making stranded cost recovery

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[10] Compelled divestiture of a public service corporation's generation assets merely to value stranded costs also violates constitutional guarantees of due process and equal protection. *See* U.S. Const. amends. V & XIV; Ariz. Const. art. 2, § 4 & art. 2, § 13; *Bryant v. Continental Conveyor & Equip. Co.*, 156 Ariz. 193, 197, 751 P.2d 509, 513 (1988), *overruled on other grounds*, *Hazine v. Montgomery Elevator Co.*, 176 Ariz. 340, 861 P.2d 625 (1993); *Big D Const. Corp. v. Court of Appeals*, 163 Ariz. 560, 566-69, 789 P.2d 1061, 1067-70 (1990).

contingent on divestiture.[11] Initial Brief of PG&E at 9; Citizens' Initial Brief at 15. Such a disingenuous proposal will not withstand judicial scrutiny, and the Commission cannot conclude that it has authority to indirectly compel divestiture.

VII. INVOLUNTARY RATE CAPS WOULD BE UNREASONABLE, ANTI-COMPETITIVE, AND UNLAWFUL

Although rate caps were largely discussed during the working group process as a cap on the "Affected Utilities'" bundled "standard offer" rates, some would now apply the concept even to unbundled rates offered by "Affected Utilities." Neither proposal is lawful under any regulatory scheme, neither is consistent with true competition, and neither makes any sense.

All regulated utilities are entitled to charge rates that are both just and reasonable and which allow them to recover their reasonable costs and earn a reasonable return on the fair value of their property. *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145 (1956). Although the Commission may have made such a determination for each of the "Affected Utilities" at some time in the past, it cannot simply assume without any evidence that such rates necessarily will continue to be just and reasonable for some specified time into the future. Moreover, even if the Commission can substitute a "market" determined price for one determined with reference to fair value, the Commission cannot impose any arbitrary *per se* cap on what such a just and reasonable market price will be.

The following example will demonstrate both the unreasonableness and unlawfulness of a involuntary cap applied to an "Affected Utility's" unbundled rates. Assume APS' present fully bundled rate is 7 cents per kWh. It then unbundles this rate into 3 cents for competitive generation,

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[11] PG&E, for example, claims that their "voluntary" divestiture proposal was discretionary, and claims that Mr. Fessler acknowledged this. Initial Brief of PG&E at 9. All that Mr. Fessler acknowledged, however, was that choosing between divestiture or no stranded cost recovery "would have an *element* of discretion in it." 2 Tr. 586 (emphasis added). Moreover, California did not coerce divestiture, as Mr. Fessler took pains to demonstrate, when it negotiated the partial sale of the non-nuclear assets of some California utilities. Mr. Fessler stated that the Commission "emphatically did not require [divestiture]." 2 Tr. 523. Indeed, California has selected administrative valuation for those assets which are not divested. Preferred Policy Decision at 54-55. Further, tying divestiture to securitization, rather than denying stranded cost recovery, is not the equivalent of coercing divestiture; the utility is still entitled to recover its stranded costs. *See, e.g.,* Mass. Gen Laws ch. 164, § 17(B) (1996).

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3.5 cents for transmission/distribution, and .5 cents for a stranded cost transition charge. Subsequently, the formerly fully bundled rate customer in our hypothetical switches to Enron for competitive electric generation at 2.75 cents per kWh. Under the cap scenario, if Enron subsequently raised its price above 3 cents (and none of the "cap" advocates would apparently propose that Enron be prohibited from doing so), APS would have to reduce its rates to keep the customer's "all in" price at 7 cents. Aside from the fact that this would provide Enron with an incentive to raise its prices, it would result in APS charging below cost rates for distribution/transmission and assessing its transmission/distribution customers different prices for the same regulated services, depending on what the generation provider was charging. If that is not discrimination, the Company does not know what else to call it. Even if APS were also the competitive generation supplier, and market prices subsequently rose above 3 cents in our example, APS would be effectively prevented from charging such a market price because of the cap. This places the Company in the position of charging below market rates to its own transmission/distribution customers but presumably higher rates to others - something with which APS suspects its competitors would take great issue. Note that the same anticompetitive result will obtain if the Standard Offer rate is capped.

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Several of the parties herein have expressed concerns as to whether this or that consumer group will actually benefit from competition. Those concerns are legitimate. However, there are simply no guarantees in a competitive market, and attempting to create such a guarantee though requiring "Affected Utilities" to "insure" all customers against rising market prices (without allowing them to charge an insurer's premium) is both illogical and confiscatory.

VIII. MISCELLANEOUS ISSUES

A. Stock Valuation Method of Stranded Cost Calculation

Despite the shrill rhetoric and sniping at both APS' positions herein and the current regulatory environment, the Attorney General has offered a novel scheme to measure and recover certain stranded costs.[12] However, its largely theoretical approach (it has never been utilized in practice) ultimately fails for a variety of legal, economic and practical reasons.

The Commission has no authority to order Pinnacle West, the parent company of APS, to create and issue publicly traded preferential stock rights. The Attorney General has offered no analysis that such an extraordinary action is within the Commission's power. Additionally, there is no reason to believe that the creditors and preferred stockholders of APS would voluntarily consent to the denigration of their bargained-for preferential rights by agreeing to the diversion of revenue flows from the Company to lower tier common shareholders.

Equally importantly, the "valuation" of stranded costs proposed by the Attorney General's method could, given the vagaries of the stock market, vary significantly, depending upon the time frame selected for the valuation. The market price valuation will also necessarily depend on a number of variables completely unrelated to an estimate of stranded costs (such as interest and inflation rates, economic forecasts of productivity, national and international events, and other exogenous variables). As a result, this method will necessarily over- or under-estimate actual stranded costs through timing differences and "contamination" from irrelevant external events. *See* 12 Tr. 3696-3698 (E. Lopezlira).

More fundamentally, however, is the inherent circularity of the Attorney General's approach. Investors are to somehow "value" stranded costs, yet the Attorney General's proposal offers no basis upon which investors could make a valuation of stranded cost recovery other than the market's own speculation concerning those values. The Attorney General's proposal provides for *no* Commission action or pronouncement upon which to base such an independent valuation. The exercise is thus pointless.

Perhaps the most significant flaw[13] is the failure of the plan to address the real stranded cost

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[12] The Attorney General's proposal apparently does not include APS' regulatory assets, the treatment of which its witness agreed should <u>not</u> be changed from earlier Commission orders. (12 Tr. 3980)

[13] Other deficiencies include the impact on rates caused by accelerating stranded cost recovery into a five-year time period and the likelihood that investors would be justifiably skeptical that deposit of stranded cost payments into a Commission-administered fund would ever, in fact, be paid out to common stockholders.

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problem. By requiring payment to be made directly to common stockholders, the proposal deprives utilities of the revenues necessary to pay the actual stranded costs (*e.g.*, generation costs, debt obligations related thereto, purchased power costs, etc.). In other words, if competition renders an "Affected Utility" unable to secure sufficient revenues to meet millions of dollars in stranded costs (which it is legally obligated to pay), payments to the Company's shareholders would not solve the utility's revenue deficiency. When queried on this point, the Attorney General's witness had no idea where an "Affected Utility" would obtain such money. 12 Tr. 3987 (E. Lopezlira). In fact, the witness could think of no reason why the bondholders and creditors of an "Affected Utility" would agree to a scheme that would deprive the Company of the revenues necessary to pay stranded costs. 12 Tr. 3988 (E. Lopezlira).

In short, the Attorney General's proposal, although arguably creative, is fatally flawed and could not be practically or lawfully adopted.

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B. Request of the Arizona School Boards Association to Be Exempt from Stranded Cost Obligations

The Arizona School Boards Association ("ASBA") has requested an exemption from any stranded cost payment obligations because of the school funding "crisis" in Arizona. In its initial brief, the ASBA offers no legal support for the contention that a legislatively-created revenue shortfall should be funded by the shareholders of "Affected Utilities," rather than by society as a whole or a broader group of customers or generation suppliers.[14] Nor does the ASBA explain why such preferential treatment would not be unlawful under the anti-preference, anti-discrimination provisions of Title 40 and the Arizona Constitution. Granting the ASBA request would clearly open the floodgates for every arguably worthwhile enterprise (both public and private) to claim that its funding problems necessitate relief from the imposition of otherwise just and reasonable rates and entitle it to subsidies from others. It would seem bad regulatory policy to encourage such special interest

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[14] ASBA has apparently not sought or received similar concessions from any other providers of goods and services to its members.

"begging." *See* 9 Tr. 2770-2773 (T. Broderick).

C. Code of Conduct and Subsidization Issues

Several parties have urged the Commission to adopt in this proceeding restrictions on electric service-related activities that can be engaged in by "Affected Utilities" that could raise questions of inappropriate subsidization or market power dominance. Although the issue itself is legitimate, no party has presented any evidence demonstrating that "Affected Utilities" have engaged in, or are planning to engage in, any activities that would justify the draconian prohibitions advanced by such parties. Such recommendations are particularly suspect when raised by potential entrants seeking to stifle legitimate competition from Affected Utilities. APS already complies with the functional separation requirements of FERC Order 888 and will continue to operate in a lawful and prudent manner. The proper place for examining market structure issues is in a separate proceeding focusing on such issues, as APS has repeatedly urged. It should not be slipped in as an afterthought in a generic stranded cost proceeding.

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IX. CONCLUSION

Based both on Decision No. 59943 and the prior rate agreements between the Company and the Commission, investors have had every reason to believe that APS would be given a reasonable opportunity for full recovery of stranded costs. No party has presented a persuasive or even credible justification for a change in this Commission's treatment of these costs, which are currently reflected in the Company's approved rates and charges.

Herein, APS has proposed a methodology for measuring and recovering stranded costs that would allow it an opportunity for full recovery but would constitute far less than a guarantee. This methodology removes most of the guesswork and "crystal balling" required in other calculations of stranded costs. It avoids the cost, delay and uncertainty involved in auction/divestiture schemes. Moreover, it is a methodology that the Company can easily employ prior to January 1, 1999. In fact, the Company stands ready to make its stranded cost filing for 1999 within thirty (30) days of an entry of an order in this proceeding.

APS asks the Commission to reaffirm its commitment to full stranded cost recovery in no uncertain terms. It further asks that the Commission indicate its approval in principle, at least for APS, of the stranded cost measurement and recovery mechanism suggested by Mr. Davis. Finally, there are numerous changes to the Rules set forth in Mr. Davis' testimony that will serve to clarify and simplify their future application and thus hasten full competition. The Commission should institute the necessary rulemaking proceeding to implement these changes.

RESPECTFULLY SUBMITTED this 23rd day of March, 1998.

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CERTIFICATE OF SERVICE

The original and ten (10) copies of the foregoing document were filed with the Arizona Corporation Commission on this 23rd day of March, 1998, and service was completed by mailing or hand-delivering a copy of the foregoing document this 23rd day of March, 1998, to all parties of record herein.

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