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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.

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I. INTRODUCTION

Pursuant to the Commission's March 3 Procedural Order, the parties to this proceeding submitted Initial Briefs on March 16 addressing the eleven key issues identified in the Hearing Division's Procedural Orders.[1] The Residential Utility Consumer Office ("RUCO") hereby files its Reply to those Initial Briefs.

In this brief, RUCO responds to proposals made by other Parties in their Initial Briefs in instances where the parties' proposals would be harmful to the public interest, especially where they would harm the interests of residential utility ratepayers. Failure to address issues raised by other parties does not, however, signify a change in RUCO's position on a particular issue. RUCO's position on the eleven issues remains unchanged unless specifically stated otherwise herein. This brief first addresses the Affected Utilities' "regulatory compact" arguments, and then responds to each of the eleven issues identified in the Procedural Orders.[2]

II. "REGULATORY COMPACT"

RUCO contends that in this proceeding there is no legal basis for the Affected Utilities' arguments regarding the purported existence and effect of the "regulatory compact" they claim.[3] However, because the Affected Utilities have chosen to argue these points in their initial briefs, RUCO will respond to those arguments.

Citizens Utility Company ("Citizens") devotes the first six pages of its initial brief to a summary of Citizens *Re Utilities Company Kauai Electric Division*.[4] Tucson Electric Power Company ("TEP") also references *Kauai*.[5] Citizens concedes that the *Kauai* case is not

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[1]Arizona Corporation Commission Hearing Division Procedural Orders of December 1, 1997 and December 11, 1997.

[2]Id.

[3]See note 13, *infra*.

[4]Citizens Initial Brief at 4, citing *Re Citizens Utils. Co., Kauai Elec. Div.*, Docket Nos. 94-0097 and 94-0308, dated August 7, 1996, Slip Opinion.

[5]TEP Initial Brief at 10.

controlling legal authority.[6] This is correct; the *Kauai* case has nothing to do with electric restructuring or the implementation of a competitive generation market. Instead, the Hawaii Commission's decision is based on Kauai's regulated utility status.[7] Citizens quotes: ". . . as a regulated utility KE [Kauai Electric] has a duty to restore services as quickly as possible. It has no option to cease operations."[8] Citizens acknowledges that "in contrast, a competitive business can studiously decide, based upon its forecast of business conditions, whether to restore or to cease operations. . . "[9] It is this contrast between a regulated business and a competitive business that distinguishes *Kauai* and other like cases[10] from the issue currently before the Commission.

After restructuring is complete, Arizona's Affected Utilities will be free to use their generation assets in the competitive market, if they so desire. At that time, their property will no longer be "devoted to the public use" and therefore will no longer be guaranteed a regulated rate of return. Just as importantly, their property will no longer be limited to a regulated rate of return. The *Kauai* decision was based on the fact that the property in question was regulated, "used and useful property."[11] Kauai Electric's transmission and distribution system, when damaged, was comprised of regulated assets, devoted to the public use, and the assets retained that status once repaired. This single fact distinguishes the *Kauai* decision in a fundamental way from the decision this Commission must make on Affected Utilities' stranded costs determinations. The very reason that the Commission is making stranded cost determinations is that the Affected

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[6]Citizens Initial Brief at 1.

[7]The *Kauai* decision appears to address only transmission and distribution plant replacement and repair.

[8]Citizens Initial Brief at 4, citing *Kauai*, Slip Op. at 14-15 (emphasis added).

[9]Citizens Initial Brief at 6.

[10]In an Exhibit attached to its Initial Brief, TEP cites several cases for their use of the term "regulatory compact." TEP Initial Brief at 27-28. TEP fails, however, to provide the Commission with a legal basis for applying that term or concept to the issues in this proceeding.

[11]Kauai Elec., Slip Op. at 14.

Utilities' generation assets will no longer be regulated when the transition to a competitive generation market is complete.[12]

Even if the Commission were to put aside the fact that Citizens' and other Affected Utilities' regulatory compact arguments constitute an impermissible collateral attack on Commission Decision No. 59943,[13] the Commission should disregard any "case law" supporting the existence of a regulatory compact when that case law is based on factual situations that have nothing to do with transitioning to a competitive market.

If the Commission seeks guidance from prior court decisions, it should look to decisions involving facts related to other jurisdictions transitioning to competition. The New Hampshire Supreme Court has decided such a case.[14] The facts of that case are similar to those currently before the Arizona Supreme Court.[15] The New Hampshire Supreme Court addressed the transition to a competitive generation market and decided that it was in the public interest to allow the New Hampshire Public Utility Commission to alter Public Service Company of New Hampshire's CC&N when transitioning to a competitive generation market.[16] In Arizona, Judge

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[12] A.A.C. R14-2-1606(A).

[13] RUCO agrees with the legal arguments made by Commission Staff ("Staff") in its Opening Brief at 11-13 and those made by Intervenors Ajo Improvement Company, Morenci Water & Electric Company and Phelps Dodge Corporation ("Ajo et al") in their Initial Brief at 2-5 regarding impermissible collateral attack on the Rules.

[14] *Appeal of Pub. Serv. Co. of New Hampshire*, 676 A.2d 101 (N.H. 1996). The applicability of this case to Arizona's transition is more fully explained in Arizonans for Electric Choice and Competition, ASARCO Incorporated, and Cyprus Climax Metals Company's ("Arizonans for Electric Choice") Initial Brief at 26-28.

[15] *Trico Elec. Coop, Inc. v. The Honorable Michael B. Dann, Judge of the Super. Ct. In and for the Cty. of Maricopa, and the Arizona Corp. Comm'n*, Maricopa County Super. Ct. Cause No. CV 97-03928; *Arizona Elec. Coop. et. al v. The Honorable Michael B. Dann, Judge of the Super. Ct. In and for the Cty. Of Maricopa, and the Arizona Corp. Comm'n*, Maricopa County Super. Ct. Cause No. CV 97-03928; Petitions for Special Action filed on March 5, 1998.

[16] *Appeal of Pub. Serv. Co. of New Hampshire* at 106.

Campbell, in his ruling on *Tucson Elec. Power Co. v. Arizona Corp. Comm'n* came to a similar conclusion of law regarding the effect of the transition to competition on TEP's CC&N.[17]

III. THE ELEVEN STRANDED COST ISSUES

ISSUE 1: Should the Electric Competition Rules be Modified?

RUCO strongly objects to Arizona Public Service Company's ("APS") suggestion that Section J of Rule R14-2-1607 be deleted.[18] RUCO's proposed change to that Section as noted in Attachment 1 to this brief[19] accomplishes two important goals. It ensures that all customers who utilize the distribution system will pay the CTC and also assures that the CTC will be based on the amount of generation consumed. This assures revenue neutrality in the collection of the CTC, if any is to be collected. If there is to be any recovery of stranded costs from customers, the recovery should be allocated fairly across all customer classes.[20]

APS also asks the Commission to modify the Rules to recognize that a 1996 cut-off date for consideration of stranded costs is arbitrary.[21] It appears, however, that the costs APS is asking the Commission to recognize in this instance are transmission and distribution costs, and not generation-related costs. The Rules as currently framed would allow APS or any other Affected Utility to request an increase in distribution or transmission rates at any time.[22]

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[17]*Tucson Elec. Power Co. v. Arizona Corp. Comm'n*, No. CV 97-03748 (Consolidated)(". . . TEP does not have a right to its regulated monopoly in perpetuity; rather, TEP's CC&N can be amended, altered or revised through a section 40-252 hearing to take away its exclusive right to generate electricity for its area.")(Minute Entry of January 3, 1998 at 3).

[18]See APS Initial Brief at 5.

[19]RUCO's proposed modifications to the Rules appear in Attachment 1 to this brief. Please note that in RUCO's Initial Brief, there were typographical errors in its strikeout version of A.A.C.-R-14-2-1608(A). Those errors are corrected in Attachment 1 to this Brief.

[20]See The Land and Water Fund of the Rockies, The Grand Canyon Trust and Arizonans for a Better Environment ("LAW Fund") Initial Brief at 7-9.

[21]APS Initial Brief at 2-4.

[22]A.A.C. 14-2-1606(B)(2-3).

Therefore, there is no need for a change to the rules to allow APS to request recovery of such costs. Arguments such as the one APS makes here accentuate the need for the Commission to establish specific generic unbundling requirements as soon as possible, prior to a final decision on stranded cost recovery.

Ajo et al., PG&E Energy Services and Enron Energy Services all urge the Commission to adopt rules to prevent cross-subsidization of competitive services by Affected Utilities' regulated rates.[23] RUCO agrees that such rules are reasonable and necessary.

Ajo et al. also recommend in their Initial Brief that the Commission develop requirements for horizontal and vertical market power analysis.[24] RUCO agrees that this is an important step, and has made a similar suggestion in the past.[25] RUCO suggests that the Affected Utilities be required to make filings in compliance with Commission-determined market power analysis criteria within the true-up process.[26]

RUCO agrees with APS that it would be reasonable to change R14-2-1607A to replace every "feasible" cost effective mitigation measure with every "reasonable" cost effective measure. However, the burden of proof to show mitigation should rest with the utilities.[27]

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[23]See Ajo et al. Initial Brief at 24-25. The City of Tucson also agrees that the Commission has a duty to monitor and discourage occurrences of cross-subsidization. City of Tucson Initial Brief at 14.

[24]See id. at 28.

[25]See RUCO's Advocacy Comments to the Unbundling Working Group Report, filed with the Commission on October 29, 1997.

[26]See "Issue 9," *infra*.

[27]See "Issue 3," *infra*.

ISSUE 2: When Should Affected Utilities be Required to Make a Stranded Cost Filing Pursuant to A.C.C. R-14-2-1607?

Citizens claims that until the Commission reviews all of the evidence and provides further guidance, it is simply not possible for Affected Utilities to make responsive stranded cost filings.[28] However, some witnesses in this proceeding stated that without an estimate of stranded cost amounts from the Affected Utilities, the Commission has no factual basis upon which to base its policy decision.[29]

RUCO contends that whatever date the Commission sets for stranded cost filings, all parties must have sufficient opportunity to review and analyze a company's filing before competition is implemented. Stranded cost claims should therefore be filed at the earliest date possible, so that the Commission can establish an equitable level of stranded cost recovery in a timely manner.

ISSUE 3: What Costs Should be Included as Part of Stranded Costs and How Should They be Calculated?

1. Stranded Cost Calculation Methodology

All stranded cost calculation methodologies require an administrative valuation to assure reasonableness. Even if auction and divestiture is used to value Affected Utility property for the purpose of determining stranded costs, Arizona law requires that the Commission utilize some sort of an administrative valuation approach and true-up, if necessary, to assure the reasonableness of the sale price of the utility's assets.[30]

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[28]Citizens Initial Brief at 12.

[29]Dr. Coyle (City of Tucson) TR. at 1065.

[30]See RUCO Initial Brief at 21-22, citing *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956) (the reasonableness and justness of rates must be related to fair value finding); RUCO Initial Brief at 28-29, citing *City of Tucson v. Citizens Utils. Water Co.*, 17 Ariz. App. 477, 481, 498 P.2d 441, 555 (App. 1972)(fair value finding must be supported by substantial evidence); RUCO Initial Brief at 29, citing *Arizona Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 ("...the purchase price of a public utility does not constitute, as a matter of law, its fair value.").

While RUCO is opposed to coerced or forced divestiture, RUCO is not opposed to voluntary divestiture. The Affected Utilities agree with RUCO on this issue.[31] Use of the administrative approach does not inhibit voluntary divestiture. Despite the additional costs associated with an auction and divestiture method,[32] RUCO believes it is reasonable to allow the Affected Utilities to either voluntarily divest or choose an administrative valuation methodology for determination of stranded costs. TEP proposes that "auction and divestiture remain an option throughout the recovery period no matter what methodology is finally decided upon."[33] The use of the administrative approach does not inhibit divestiture, whether partial or full, of generation assets.

Under RUCO's methodology, voluntary divestiture could be accomplished with assurances of reasonableness. Following an administrative net-system valuation stranded cost determination, an Affected Utility could voluntarily divest itself of generation assets. Then, in order to assure that the sale price was reasonable, the Commission could true-up initial stranded cost estimates, taking the sale price due to divestiture into account as partial evidence as to the competitive market value of the divested assets. This approach addresses the concern some parties have raised regarding partial divestiture.[34]

RUCO's proposed methodology also accommodates concerns of the parties regarding negative stranded cost recovery. Staff states in its Initial Brief that "there is no mechanism being proposed for the refund to ratepayers of competitive gains."[35] RUCO does propose such a

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[31]TEP Initial Brief at 2; Citizens Initial Brief at 22; APS Initial Brief at 17-18.

[32]RUCO agrees with Staff that the auction price methodology is a more complicated process than has been portrayed. See Dr. Rose (Staff), TR. at 3128-3131. The Commission would have to approve the auction process as well as evaluate its results. RUCO Initial Brief at 9. Additionally, the auction process itself would not eliminate market power concerns. City of Tucson Initial Brief at 9.

[33]TEP Initial Brief at 2.

[34]See Electric Competition Coalition, Enron Corporation, and Enron Energy Services, Inc. ("ECC and Enron") Initial Brief at 15, citing Dr. Alan Rosenberg (Arizonans for Electric Choice), TR. at 2257.

[35]Staff Initial Brief at 4.

mechanism.[36] Presumably, the competitive gains Staff refers to are negative stranded costs. The existence of future competitive revenues and their treatment comprise an integral part of RUCO's proposal. Under RUCO's proposal, any negative stranded costs, whether due to the Affected Utilities' future competitive generation revenues or their past overearning on regulated generation assets, be refunded to the ratepayers. If an Affected Utility has positive stranded costs, the negative "stranded costs" occurring as a result of future competitive revenues are netted against the positive costs.

Due to the potential controversy that might surround implementation of Staff's proposal to avoid precise calculation of stranded costs,[37] RUCO suggests that the Commission consider utilizing RUCO's "top down" administrative valuation approach instead. Staff suggests that it is possible to avoid examination of mitigation efforts and avoid using a true-up mechanism.[38] RUCO finds this suggestion untenable and ill-advised. Accuracy and equity in stranded cost recovery require Commission oversight.[39] No other party has proposed a workable methodology to assure the just and reasonable determination of stranded cost recovery that Arizona law requires.

Staff generally agrees that RUCO's proposal, which "requires a comparison between the revenues generated for a utility in a competitive generation market and those generated in the current regulated market" involves "a calculation well suited to the administrative process, and can be accomplished in a reasonable time frame."[40] Staff's proposal requires the Affected Utilities to provide "top down" estimates of their alleged stranded costs, utilizing retail, rather than

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[36]Dr. Rosen (RUCO), TR. at 1931.

[37]Public Service Corporation property devoted to the public use must be fairly valued in order to set just and reasonable rates and charges. Ariz. Const. art. 15, §§ 3, 14; *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (Ariz. 1956).

[38]Staff Initial Brief at 30.

[39]See note 7, *supra*.

[40]Staff Initial Brief at 10.

wholesale prices, and using the expected life of the generation assets.[41] Thus, Staff has generally accepted the most essential requirements of RUCO's proposed calculation methodology.

2. What Costs Should Be Included in Stranded Cost Calculations?

RUCO contends that after properly unbundling the utility's current embedded costs-of-service, the embedded cost of generation will be known. Therefore, the uneconomic portion of generation assets, generation-related operation and maintenance costs, purchase power agreements, fuel contracts, generation-related regulatory assets and liabilities, and generation-related A&G expenses should be considered strandable costs. RUCO contends that nuclear plant decommissioning costs and nuclear fuel disposal costs are by their nature directly related to generation and therefore should be considered part of strandable costs.[42] APS argues that in addition to nuclear decommissioning costs, nuclear fuel disposal costs should be recovered as a System Benefits charge.[43] RUCO is opposed to this treatment because both of these costs are inherently related to generation. As such they should be unbundled with the generation component in order to maintain internal consistency within the administrative valuation methodology.

Some parties have raised the issue of possible misallocation of uncontrollable sunk costs to transmission and distribution services so as to make an Affected Utility's generation more competitive in other markets.[44] RUCO agrees that misallocation of uncontrollable sunk costs to transmission and distribution services should be avoided. Proper unbundling of rates into separate rates for customer services, transmission, distribution and retail generation services will

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[41]Staff Initial Brief at 28.

[42]For a fuller explanation, please see RUCO Initial Brief at 14-15. RUCO's proposed modifications to the Rules, included as Attachment 1 to this brief, include this change.

[43]APS Initial Brief at 2.

[44]ECC and Enron Initial Brief at 16, citing Dr. Mark Cooper (Arizona Consumers Council), TR at 2481, and referring to Dr. William Hieronymus (APS), TR. at 2694-2696.

minimize misallocation of these costs. This is why RUCO insists that unbundling of rates must be accomplished correctly and quickly. All parties must have the opportunity to participate in the unbundling proceedings to insure that no party is disadvantaged by the process.

3. **<u>The Burden of Proving Strandable Costs Are Stranded Should Lie With Those Requesting Reimbursement.</u>**

Not all <u>strandable</u> generation costs will become <u>stranded</u> by the introduction of competition. It would be incorrect and inexpedient to place the burden of proof for inclusion of costs for recovery from ratepayers upon the parties opposing such inclusion, as Citizens suggests.[45] In their Initial Brief, intervenors Ajo et al. provide an excellent explanation of the highly undesirable procedural effects of placing the burden of proof on the wrong party.[46]

ISSUE 3a: What is the Appropriate Treatment of Market Price?

1. **<u>Market Price Estimates Must Reflect A Retail Market Price, Not A Wholesale Market Price.</u>**

RUCO contends that a retail market price must be used in calculating stranded costs. Other parties agree.[47] The shortfalls of the wholesale-based Dow Jones Palo Verde Index and the California Power Exchange as a measure of retail market price were a subject of accord among many of the parties.[48] The Affected Utilities have not proffered any alternative to these wholesale indices, although they concede that they may be inappropriate. TEP acknowledges that the Dow Jones Palo Verde Index is an uncertain measure of market price, but recommends

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[45]Citizens Initial Brief at 11.

[46]Ajo et al. Initial Brief at 11-14.

[47]Ajo et al. Initial Brief at 22-23 (imploring the Commission to reject use of wholesale prices to compute stranded costs and instead develop a retail market price for competitive generation); ECC and Enron Initial Brief at 13 (advocating adding unbundled tariff components to a wholesale index for its appraisal method).

[48]<u>See</u> Ajo Improvement et al Initial Brief at 22-23; ECC and Enron Initial Brief at 21-23.

its use nonetheless.[49] APS acknowledges that the California Power Exchange may not provide a proper measure: "APS' methodology compares the actual market price for generation (as established by the California Power Exchange or some other comparable market index) with the Company's actual generation cost."[50]

APS tries to defend its too-low wholesale generation market price indicator by citing the rebuttal testimony of Dr. Hieronymus.[51] APS cites: "A utility generator *does not and cannot earn* retail margins."[52] In the same paragraph, however, Dr. Hieronymus refers to the "competitive cost of the retailing function."[53] Dr. Hieronymus seems to be overlooking the fact that the very reason for restructuring is to allow electricity generators to bypass wholesalers and sell electricity to end users at retail prices. Deregulation of the generation component of rates does not mean that individual residential customers will buy electricity at the same rates as an Affected Utility. When generators sell to end users, they will incur retail costs. This factor is what necessitates use of a retail as opposed to a wholesale market price for stranded costs calculations.

To estimate retail market price in the most accurate way, the Commission should start with an appropriate wholesale price and then add a retail "margin" (discussed below) to account for retailing costs. The Palo Verde Index, as a short-term spot market price, does not reflect the higher prices of long-term contracts for firm capacity purchases and therefore should not be used. A more appropriate estimate of a wholesale market price requires a "least cost planning" analysis. A proper wholesale price estimate to meet a certain type of load, such as peaking, cycling, or baseload, should be no less than the unit cost of financing, constructing, and operating those

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[49]TEP Initial Brief at 16.

[50]APS Initial Brief at 7.

[51]APS Initial Brief at 15-16.

[52]Id.

[53]Id.

plants needed to meet that load in the least-cost way over the long run. Ancillary service costs and the impact of T&D losses must also be taken into account.[54]

2. A "Retail Margin" Is Necessary to Properly Estimate Retail Market Price.

RUCO contends that generation-related A&G expenses, billing service costs, customer service costs, marketing and other transaction costs should be included in retail market price estimates.[55] In a recent decision on stranded cost recovery, the Pennsylvania Public Utility Commission allocated generation-related A&G expenses to the generation function.[56] Other parties in this docket support this treatment.[57] These costs, which must be incurred by competitive generation suppliers and Affected Utilities alike in order to deliver generation to the end user, can then also be reflected in the standard offer generation price component. Having a market-based generation rate for the standard offer is important in that it is the only way to realistically allow competitive entry into the market.

ISSUE 3b: What are the Implications of Financial Accounting Standard No. 71 Resulting from this Approach?

If the Commission allows recovery of generation-related regulatory assets, those assets should be unbundled as generation costs for purposes of stranded costs recovery.[58]

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[54]See RUCO Exhibit 1 at 41-47 for a complete discussion of the wholesale market price projection methodology.

[55]These are the same costs that should be included in the generation component of unbundled rates.

[56]*Application of PECO Energy for Approval of its Restructuring Plan*, Docket Nos. R-00973953, P-00971265, Final Opinion and Order entered December 23, 1997 at 48, 58.

[57]Ajo et al. Initial Brief at 23; ECC and Enron Initial Brief at 13, citing Dr. Rose (Staff), TR. at 3094-3095, 3165-3166 (advocating determination of a retail market price for Arizona)(emphasis added); AECC Initial Brief at 12 ("Components of the average retail market price will include the underlying wholesale price of power, plus a retail markup.")(emphasis added).

[58]See RUCO Initial Brief at 31.

ISSUE 4: Over What Period Should Stranded Cost Calculations Be Made?

RUCO believes that it would be against the public interest to calculate stranded costs over any period shorter than the operational life of the generation asset under consideration.[59] RUCO definitely does not favor limiting the calculation period to a three to five year transition period.[60]

APS' proposal to make the calculation period for stranded cost recovery equal the recovery period for stranded cost recovery would lead to a gross overestimation of stranded costs.[61] As Citizens stated in its Initial Brief, "this would allow APS to recover all above-market costs between now and the year 2006 and then keep all the below-market costs after that date."[62] TEP also agrees that "[p]roper quantification of stranded costs should reflect the remaining life expectancies of these underlying assets and associated costs."[63] It is not surprising that APS characterizes this proposal as "the most significant problem" with RUCO's administrative valuation approach;[64] this is the key factor to RUCO's estimation that APS has negative stranded costs. Even more telling is APS' admission that the remaining life of its generation assets "could be decades."[65]

The ECC and Enron state that the longer the calculation period, the less accurate stranded cost estimates will be.[66] This statement fails to account for the accuracy added to stranded cost calculations by using the operational life of the assets to calculate those costs. Including the

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[59]See RUCO Initial Brief at 19-22.

[60]Arizonans for Electric Choice erroneously state that RUCO favors such a limitation in their Initial Brief at 14.

[61]Citizens Initial Brief at 24; ECC and Enron Initial Brief at 23.

[62]Citizens Initial Brief at 19; See also ECC and Enron Initial Brief at 23.

[63]TEP Initial Brief at 3.

[64]APS Initial Brief at 7.

[65]Id.

[66]ECC and Enron Initial Brief at 15, citing Mr. Bayless (TEP), TR. at 1515-1516.

later, more profitable years of generation plant is absolutely necessary for accurate calculations. In reality, the shorter the calculation period used, the more inaccurate the calculation will be because the negative stranded costs of later years will not be captured. Citizens points out that APS' proposal to calculate stranded costs only over the recovery period would overcompensate APS, and would lead to highly undesirable anti-competitive effects.[67] RUCO agrees with Citizens' analysis on this point.

ISSUE 5: Should There Be a Limitation On the Recovery Time Frame For Stranded Costs?

The recovery period for positive stranded costs, if any, should coincide with the transition period. If there are strongly negative stranded costs, the period during which consumers receive refunds may extend past the transition period.[68]

ISSUE 6: Who Should Pay for Stranded Costs and Who, if Anyone, Should be Excluded?

1. <u>How Should Stranded Costs Be Paid?</u>

A flat monthly charge for the CTC based on historic usage levels as suggested by the Attorney General and Citizens[69] poses many problems. Such a practice would not only be unwieldy and burdensome for the Affected Utilities to administer, but more importantly, would not be revenue neutral. A good explanation of the importance of revenue neutrality appears in the Initial Brief of the LAW Fund.[70] Other parties also agree that the CTC should be competitively

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[67]Citizens Initial Brief at 19 (explaining that APS' proposal "would prevent competition in APS' service territory for the next eight years, enrich APS at the expense of its customers and leave APS in perhaps the strongest competitive position in the United States.")

[68]See RUCO Initial Brief at 22.

[69]Attorney General Initial Brief at 31; Citizens Initial Brief at 25.

[70]LAW Fund Initial Brief at 7-9

neutral.[71] Additionally, Phoenix is currently a rapidly growing area, and this trend is expected to continue. While Arizona's growth may provide some mitigation of stranded costs,[72] it makes it difficult to base CTC charges on historic levels of usage.

RUCO agrees with Staff's recommendation, adopted by ECC and Enron, that the stranded cost charge should appear as a line item on the bills of all customers, including those on standard offer, so that consumers are better equipped to comparison-shop.[73]

2. Who Should Pay For Stranded Costs?

RUCO believes that the most reasonable and equitable way to deal with unmitigated stranded costs is to have ratepayers and shareholders share the hardship of paying for them. Because neither shareholders nor ratepayers are 100% responsible for costs that might be stranded by the transition to a competitive generation market, neither deserves 100% exemption from payment. Saddling ratepayers with 100% of the burden would be just as inequitable as forcing shareholders to bear 100% of the burden.

TEP suggests that only the Affected Utilities stand to suffer adverse economic effects from the transition to competition.[74] This is simply not the case. It is not true, as TEP claims, that consumer groups have "everything to gain and nothing to lose through competition."[75] It is the small consumer that stands to lose the most if the restructuring of the electric industry is improperly implemented. While ratepayers may not have directly invested in this state's electric infrastructure "like the Affected Utilities have,"[76] ratepayers have certainly been paying for the

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[71]APS Initial Brief at 9; City of Tucson Initial Brief at 12.

[72]LAW Fund Initial Brief at 3.

[73]ECC and Enron Initial Brief at 4, citing Dr. Rose (Staff), TR. at 3242.

[74]TEP Initial Brief at 6.

[75]TEP cites as "authority" for this proposition its own opening statement made in this proceeding. TEP Initial Brief at 7.

[76]TEP Initial Brief at 7.

costs of Affected Utilities' generation infrastructure through rates; if they had not, the Affected Utilities' plants would not have been built.

TEP's witness agreed that there has never been a "100% guaranteed result" for utilities but that the utilities should be provided "with a comparable opportunity" to earn a fair return on their investment.[77] RUCO believes that this logic applies equally to assurances that ratepayers are not responsible for paying Affected Utilities' uneconomic costs. Ratepayers have never had 100% assurance that they would not pay for uneconomic utility costs, but they should retain at least the same safeguards against this occurrence as they had before competition. In RUCO's view, the only way to meet the competing expectations of shareholders and ratepayers in this situation is to share the burdens associated with the transition. It is RUCO's belief that the transition to competition will allow shareholders and ratepayers to share the benefits of competition as well.

APS cites four reasons against sharing stranded costs: 1) the promotion of economic efficiency, 2) the regulatory compact, 3) fairness and capital costs concerns and 4) the hastening of retail competition.[78] RUCO contends that none of these four reasons justifies placing 100% of the burden of stranded cost recovery on consumers for the following reasons: 1) the promotion of economic efficiency does not outweigh equity concerns in this matter, 2) there is no regulatory compact that assures 100% recovery of stranded costs,[79] 3)fairness dictates that neither party be benefitted to the detriment of the other; and 4) APS may be referring here to the strategy of postponing competition by litigation efforts. Sharing of stranded costs in itself will not delay retail competition.

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[77]TEP Initial Brief at 25, citing Mr. Fessler (TEP) TR. at 459.

[78]APS Initial Brief at 19.

[79]See notes 13-17, *infra*.

3. <u>Who, If Anyone, Should Be Excluded From Paying Stranded Costs?</u>

If there are positive stranded costs to be recovered, they should be recovered via a non-bypassable wires charge to every customer connected to the distribution system in an Affected Utility's service area.

ISSUE 7: Should There be a True-up Mechanism and, if so, How Should it Operate?

A true-up is required to ensure equity and accuracy. Even with divesture, the Commission should retain the ability to review sales of generation assets and the sale prices for reasonableness.[80] This is particularly true where a potential for less than arms-length transactions exists, e.g., where a utility transfers a power plant to a related entity.[81]

Contrary to the concerns expressed by ECC and Enron, under RUCO's approach, the Affected Utilities would not be entitled to recover all revenue changes that might occur in the future, without regard to the effect competition will have on the utility.[82] Future competitive revenue changes are accounted for in original estimates of stranded costs. The administrative valuation methodology proposed by RUCO yields a total estimated value for all of Affected Utility's strandable costs on a net system basis taking all generation resources and generation-related costs, assets, and liabilities into account. However, the true-up mechanism, which is an integral, inseverable component of RUCO's proposed calculation methodology is designed to adjust stranded cost calculations throughout the transition period as competitive market prices become known, and to account for future competitive revenue changes due to competition which may not have been predicted at the time of the original calculation.

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[80]DOD Initial Brief at 6.

[81]<u>Id</u>.

[82]<u>See</u> ECC and Enron Initial Brief at 14.

Intervenors Ajo et al. Suggest that each stranded cost filing made by the Affected Utilities include an affirmative analysis of vertical and horizontal market power considerations.[83] RUCO believes this to be a reasonable requirement, given that the Rules require a Commission determination of whether competition has been substantially implemented.[84] The Affected Utilities could make the required market power analysis filings in conjunction with their annual or biannual true-up that is an integral part of RUCO's stranded cost calculation methodology.

ISSUE 8: Should there be a Price Cap or Rate Freeze?

Imposition of a rate cap is an important consumer protection measure. Most parties agree.[85]

ISSUE 9: What Factors Should Be Considered For Mitigation of Stranded Costs?

The Affected Utilities should be required to reduce potentially strandable generation costs as much as possible before stranded cost recovery is allowed.[86] There is a wide range of factors that must be considered for mitigation of stranded costs.[87] In order to assure that the Affected Utilities do not over-recover stranded costs, the Commission must thoroughly evaluate mitigation efforts.[88] Measures that merely shift costs should not be regarded as mitigating stranded costs.

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[83]Ajo et al. Initial Brief at 28-29. The City of Tucson also raised market power concerns, stating that oligopoly pricing is "inevitable." City of Tucson Initial Brief at 8.

[84]A.A.C. R14-2-1606(A).

[85]AECC Initial Brief at 20; ECC and Enron Initial Brief at 5; Staff Initial Brief at 27; DOD Initial Brief at 13; ACAA Initial Brief at 3.

[86]RUCO Initial Brief at 6.

[87]DOD Initial Brief at 14.

[88]LAW Fund Initial Brief at 3.

These include voluntary write-downs of excessive generating plant costs and accelerated depreciation schedules of plant or regulatory assets.[89]

IV. CONCLUSION

Because RUCO's stranded cost calculation methodology fairly addresses and accommodates the concerns of all the parties, RUCO believes that its proposal would provide the Commission with the best available means of equitably balancing all those parties' interests. RUCO feels that implementation of its methodology would best serve the public interest, and therefore respectfully requests that the Commission adopt its proposal.

RESPECTFULLY SUBMITTED this 23rd day of March, 1998.

RESIDENTIAL UTILITY CONSUMER OFFICE

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[89]RUCO Exhibit 1 at 66-67 (Direct Testimony of Dr. Richard Rosen).

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Attachment A - RUCO's Proposed Modifications to Retail Electric Competition Rules

R14-2-1601. Definitions

In this Article, unless the context otherwise requires:

8. "Stranded Cost" means the ~~verifiable net difference between:~~ **uneconomic portion (net sunk generation costs plus unavoidable prospective costs associated with a utility's generation that cannot be recovered in a competitive market) of a utility's costs for owning and operating its generation plants, long-term purchase power contract costs, fuel supply contract costs, generation-related regulatory assets, and regulatory assets and liabilities that are generation-related but are not recoverable under competition as defined by the verifiable net difference between**:

    a. The value of all the prudent jurisdictional assets, ~~and~~ obligations **and costs** necessary to furnish electricity ~~(such as generating plants, purchased power contracts, fuel contracts, and regulatory assets),~~ acquired or entered into prior to the adoption of this Article, under traditional regulation of Affected Utilities; and

    b. The market value of those assets and obligations. ~~directly attributable to the introduction of competition under this Article.~~

9. "System Benefits" means Commission-approved utility low income, demand side management, and environmental renewables programs.

R14-2-1606. Services Required to be Made Available by Affected Utilities

B. Standard Offer Tariffs

    1. By the date indicated in R14-2-1602, each Affected Utility **must** ~~may~~ file proposed tariffs to provide Standard Offer ~~Bundled~~ Service and such rates shall not become effective until approved by the Commission. **The Standard Offer rate should be set below the rates which were in effect on December 31, 1997, and below the**

rate cap which will be established by the Commission for the period from January 1, 1999 to January 1, 2003. The generation component of the Standard Offer Service will be a market-based level for retail generation services. ~~If no such tariffs are filed, rates and services in existence as of the date in R14-2-1602 shall constitute the Standard offer.~~

3. Such rates shall reflect the costs of providing the service.

4. Consumers receiving Standard Offer service are eligible for potential future rate reductions authorized by the Commission, such as reductions authorized in Decision No. 59601.

R14-2-1607. Recovery of Stranded Cost of Affected Utilities

A. The Affected Utilities shall take every feasible, cost-effective measure to mitigate or **reduce** ~~offset~~ Stranded Cost **before steps are taken by the Commission to allocate recovery of stranded costs through cost reduction measures, such as improving the economic efficiency and productivity of generation plants, selling excess generating capacity, and renegotiating or buying out uneconomic power contracts, including non-utility generation contracts.** ~~by means such as expanding wholesale or retail markets, or offering a wider scope of services for profit, among others.~~

B. The Commission shall **determine, on a utility-by-utility basis, the factors that led to the existence of stranded costs, the ratemaking treatment the assets with uneconomic costs have received since their inclusion in the ratebase and the appropriate percentage of sharing between ratepayers and stockholders for each generating resource which contributes to stranded costs. The Commission shall allow recovery of the appropriate portion of unmitigated costs** ~~allow recovery of unmitigated Stranded Cost~~ by Affected Utilities.

H. ~~An Affected Utility shall request Commission approval of distribution charges or other means of recovering~~ Unmitigated *Stranded* Cost **eligible for recovery shall be recovered** from customers who reduce or terminate **generation** service from the Affected Utility as a direct result of competition governed by this Article **by taking generation service from alternative suppliers and from customers who stay with Standard Offer service, through a non-bypassable, non-discriminatory wires charge collected by the electric distribution company.** ~~, or who obtain lower rates from the Affected Utility as a direct result of the competition governed by this Article.~~

I. The Commission shall, after hearing and consideration of analyses and recommendations presented by the Affected Utilities, staff, and intervenors, determine for each Affected Utility the magnitude of Stranded Cost, and appropriate Stranded Cost recovery mechanisms and charges. In making its determination of mechanisms and charges, the Commission shall consider at least the following factors:

1. The impact of Stranded Cost recovery on the effectiveness of competition;
2. The impact of Stranded Cost recovery on customers of the Affected Utility who do not participate in the competitive market;
3. The impact, if any, on the Affected Utility's ability to meet debt obligations;
4. The impact of Stranded Cost recovery on prices paid by consumers who participate in the competitive market;
5. The degree to which the Affected Utility has mitigated or offset Stranded Cost;
6. The degree to which some assets have values in excess of their book values;
7. Appropriate treatment of negative Stranded Cost;
8. The time period over which such Stranded Cost charges may be recovered. The Commission shall limit the application of such charges to a specified time period;

~~9. The ease of determining the amount of Stranded Cost;~~

9.~~10~~. The applicability of Stranded Cost to interruptible customers;

10.~~11.~~ The amount of electricity generated by renewable generating resources owned by the Affected Utility.

11. The use of a retail price of generation as a baseline for establishing the price of Standard Offer Service.

J. Stranded Cost **shall** ~~may only~~ be recovered from **all** customer**s continuing to use the distribution system based on the amount of generation purchased from any supplier.** ~~purchases made in the competitive market using the provisions of this Article.~~ Any reduction in electricity purchased from an Affected Utility resulting from self-generation, demand side management, or other demand reduction attributable to any cause ~~other than the retail access provisions of this Article~~ shall not be used to calculate or recover any Stranded Cost from a consumer.

L. The Commission may order regular revisions to estimates of the magnitude of Stranded Cost.

R14-2-1608. System Benefits Charges

A. By the date indicated in R14-2-1602, each Affected Utility shall file for Commission review non-bypassable rates or related mechanisms to recover the applicable pro-rata costs of System Benefits from all consumers located in the Affected Utility's service area who participate in the competitive market. In addition, the Affected Utility may file for a change in the System Benefits charge at any time. The amount collected annually through the System Benefits charge shall be sufficient to fund the Affected Utilities' present Commission-approved low income, demand side management, environmental, **and** renewables ~~and nuclear plant decommisioning~~ programs.

B. Each Affected Utility shall provide adequate supporting documentation for its proposed rates for System Benefits.

C. An Affected Utility shall recover the costs of System Benefits only upon hearing and approval by the Commission of the recovery charge and mechanism. The Commission may combine its review of System Benefits charges with its review of filings pursuant to R14-2-1606.

D. Methods of calculating System Benefits charges shall be included in the workshops described in R14-2-1606(I).