

RE-00000C-94-165



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Thomas C. Jensen
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March 19, 1998

Honorable Bruce Babbitt
Secretary
United States Department of the Interior
1849 C St., N.W.
Washington, D.C. 20240

Honorable Federico Peña
Secretary
United States Department of Energy
1000 Independence Ave., N.W.
Washington, D.C. 20585

Honorable Robert Rubin
Secretary
United States Department of the Treasury
1500 Pennsylvania Ave.
Washington, D.C. 20220

Honorable Franklin D. Raines
Director
Office of Management and Budget
Executive Office of the President
252 Old Executive Office Building
Washington, D.C. 20503

Dear Secretary Babbitt, Secretary Peña, Secretary Rubin and Director Raines,

Several weeks ago, we wrote to you on behalf of Tucson Electric Power Company (Tucson) identifying serious legal and policy concerns regarding the Salt River Project (SRP). We asked you to investigate the matters we brought to your attention and take appropriate actions. In turn, SRP recently wrote you in response to Tucson's letters. At the risk of trying your patience, our letter today is in reply to SRP's response, and offers some new information you may wish to weigh in your deliberations.

This issue is much larger than SRP's problematic behavior. The issue at hand is whether this Administration is, through inaction, going to allow the federal electricity infrastructure to slip incrementally into private control. The landscape of electricity regulation is changing, federal assets and private businesses are coming into direct competition. The Administration must develop an overall awareness of this situation and a policy to address it.

You should be alarmed, not reassured, by SRP's response to Tucson. Other than name-calling and other attempted diversions, SRP's trivializing defense is to ask you to believe that absolutely everything we said is untrue. They ask you to believe that they are not violating preference law because their accountants can produce spreadsheets proving that millions of

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dollars of preference power provide no economic benefit to New West Energy or its customers. They would have you believe that they are not violating federal property law because federal property is not governed by federal property law. They ask you to agree that they are not violating Reclamation law because explicit contract terms somehow have no meaning anymore. They ask you to overlook their own statements made to federal and state courts because, to borrow a phrase, those statements are no longer operative.

We stand by our claims—each one of them. We again ask you to investigate and act on this serious matter. We also call to your attention the information in the attached independent report on SRP's power marketing. As you can see, ever larger amounts of federal preference power sales by the Western Area Power Administration (WAPA) to SRP are supporting ever larger power sales by SRP to private entities, such as investment banking houses, who are not themselves eligible for preference power.

What is the federal public purpose achieved by so generously propping up SRP at the expense of everybody else? Why does the United States need or permit a middleman to launder federal power into private wholesale and retail markets? Why *this* middleman?

Just this week, an energy trade publication reported that SRP is bidding to sell power to Baja California, Mexico (copy attached). If the story is true, one must ask whether Mexico is an intended beneficiary of the Reclamation and preference power programs?

This new information about SRP's escalating exploitation of its relationship with WAPA and attenuation from the intended scope of federal law and programs further clarifies the basic policy and legal issues we have asked you to address.

SRP's curious structure, its exemptions from regulatory and financial oversight, and its private use of federal benefits intended for public use, at a bare minimum, compel oversight by your departments as the competitive electricity marketplace moves forward. SRP's attacks on Tucson are irrelevant, and are intended to draw your attention away from the legitimate policy questions we raised.

This issue is complex, but it is by no means as obscure as SRP labors to make it. Indeed, the sinuous rationalizations SRP offers tend to make our point that there is something out of the ordinary going on and that the way the programs are administered at present invites evasive schemes and devices. You can cut through the legerdemain, and sort between our claims and

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SRP's response, if you ask yourself these questions:

- What is a "public power" entity that is a beneficiary of the Reclamation and preference power programs doing creating a series of for-profit businesses, abandoning cost-based pricing, and accumulating a quarter of a billion dollars in cash "for corporate purposes"?¹
- Why is WAPA providing valuable federal power to an entity with a power surplus?
- Since SRP has lost no load in its own service territory, but New West is justified solely as a tool to replace lost load, what is New West really doing in California?
- Why is a federal Reclamation project in the hands of an entity that reaps less than one percent of its annual revenues from water sales, and 99 percent from wholesale and retail power sales?
- What are the environmental effects of such generous direct and indirect subsidies to SRP water users? What is the relationship between, on the one hand, Interior and Energy's actions (or inaction) to ease water prices and, on the other hand, federal obligations and programs to restore fish and wildlife and other environmental resources throughout the Salt River basin?

And centrally:

- Regardless whether SRP/New West are distorting markets in California, the State of Arizona is now deregulating its own electricity markets. Legislation has passed the House and is pending in the state Senate. Tucson and other investor-owned utilities will be required to open their service territories. Will you permit SRP to use federal preference and project power to compete in those areas? If and when SRP faces competition in its own Arizona service territory, what rules will your agencies apply to its use of federal project and preference power there? What is your policy for all the other states that are deregulating?

¹ One gains some insight into the sensitivity of this issue by observing that SRP could not bring itself to use the word "profit" even once in the body of its response to Tucson's letters.

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In weighing SRP's blanket denials (and other statements), consider its track record of conflicting self-characterizations:

SRP on power sales' proper role:

"The Arizona Supreme court observed in *Uhlmann v. Wren*, that the district's power activities could only be 'an incidental phase of reclamation, not a primary or independent end in itself,' because the only reason for sale of power is 'the use of power revenue to support its primary irrigation and reclamation functions.'"² (1981)

But... In 1997, only approximately 3% of SRP's power revenues were used to support water operations.³ (1997)

SRP on federal property interests:

"Since it is a federal reclamation project, title to many of the Salt River Project properties is vested in the United States."⁴ (1981)

But... "SRP's assets are not 'government property' within the meaning of these laws [the Federal Property and Administrative Services Act of 1949]. The regulations define 'government property' as 'all property owned by or leased to the government,' 48 C.F.R. § 45.101(a), which is not applicable to SRP."⁶ (1998)

"The United States retains a paramount right or claim in the Project which arises from the original construction and operation of certain of the Project's electric and water facilities as a federal reclamation project. Although title to a substantial portion of the District's property, including those properties acquired pursuant to the 1917 Agreement, resides in the United States, the District possesses contractual rights to the use, possession and revenues of these properties"⁵ (1997)

² *Appellants' Jurisdictional Statement, Ball v. James*, 451 U.S. 355 (1981).

³ *See Salt River Project, Annual Report, 1996-1997*.

⁴ *Appellants' Jurisdictional Statement, Ball v. James*, 451 U.S. 355 (1981).

⁵ *Prospectus, Salt River Project Electric System Refunding Revenue Bonds, 1997 Series A*, October 1, 1997.

⁶ Letter from Kenneth C. Sundlof, Jr., attorney, Jennings, Strouss & Salmon, P.L.C. to Secretaries Babbitt, Peña, Rubin and Director Raines (March 2, 1998) (referred to herein and the attached memorandum as "SRP's

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SRP on its water function:

“SRP also subsidizes its water operations with electricity net revenues, just as any municipally-owned utilities turn over a portion of their net revenues to the municipalities’ general funds, which are then used for other municipal purposes.”⁷ (1997)

But... “[SRP’s water functions] are not analogous to the municipal water functions of a city...[T]he District and Association are not in the ‘water business’ in the same sense that a city or municipal water company might be in the water business. Their stewardship is over a federal reclamation project.”⁸ (1981)

SRP on its very essence:

“[I]t is clear that [SRP], in the conduct of its activities, including the generation, transmission and sale of electric energy, is engaged as an agency, instrumentality or conduit of the United States in the pursuit and accomplishment of a national purpose and in the rendition of a federal public service.”⁹ (1966)

But... “The District is in essence a business enterprise. Everything the District does is also done by similar private business corporations. Indeed, everything the District does *was done* by a private business corporation (the Association) before the District was formed as its mirror image.”¹⁰ (1996)

“Although the District is the creature of state law, it is engaged in a federal governmental function....Congress intended federal reclamation projects to remain under the jurisdiction of the United States and subject to its control, even after the retirement of all project debts....In generating, transmitting and selling electric energy, the District is acting under contracts between its

But... “[SRP] is virtually indistinguishable from any other utility operated for the benefit of its owners.”¹² (1981)

“Labels aside, the only functional difference between the Salt River Project and private, investor-owned utilities in the state of

Response”).

⁷ F.E.R.C., Docket No. ER98-504-000, *Answer by New West Energy Corporation* at 13 (Dec. 19, 1997).

⁸ *Appellants’ Jurisdictional Statement, Ball v. James*, 451 U.S. 355 (1981). Argument at I.A., LEXIS (citations omitted).

⁹ *Brief of Appellee, City of Mesa v. Salt River Project Agricultural Improvement and Power District*, 416 P. 2d 187 (Ariz. 1966) at 13.

¹⁰ *Appellees’ Answering Brief* at 13, *Smith v. Salt River Project Agricultural Improvement and Power District*, 109 F. 3d 586 (9th Cir. 1997).

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predecessor, the Association, with the United States....”¹¹ (1966)

“[Tucson] is incorrect to characterize the constituents of SRP as private business owners.”¹⁴ (1998). **But...**

Arizona is the District’s power to impose an ‘acreage tax.’”¹³ (1981)

“The implication that this District has ‘all the attributes of sovereignty’ is nothing less than astounding. What attributes of sovereignty? The fact that it sells electricity? The fact that it sells it to many people, some of whom live in cities? The District has no general taxing power; it has no power to enact rules governing people’s conduct or to impose punishments; it has no authority over streets, fire and police protection, schools and hospitals.”¹⁵ (1981)

SRP on its real purpose:

“[Tucson fails] to explain why SRP would choose to act in a manner that would harm its ratepayers to the benefit of the Association shareholders, where that act would also harm the very same Association electric ratepayers.”¹⁶ (1997) **But...**

“The District’s power activities are, in effect, a business venture of the landowners to reduce the cost of water deliveries.”¹⁷ (1981)

It is impossible to read this record of facile assertions and not conclude that SRP has mastered the art of gaming the legal and regulatory systems and those who govern them. Tucson respectfully suggests that your agencies, like travelers confronted with a desert mirage, should

¹¹ *Brief of Appellee, City of Mesa v. Salt River Project Agricultural Improvement and Power District*, 416 P. 2d 187 (Ariz. 1966) 14-15.

¹² *Brief of Appellants, Ball v. James*, 451 U.S. 355 (1981).

¹³ *Appellants’ Jurisdictional Statement, Ball v. James*, 451 U.S. 355 (1981).

¹⁴ SRP’s Response, *infra.*, note 6.

¹⁵ *Appellant’s Brief in Opposition to Motion to Affirm, Ball v. James*, 451 U.S. 355 (1981).

¹⁶ F.E.R.C., Docket No. ER98-504-000, *Answer by New West Energy Corporation* at 17 (Dec. 19, 1997).

¹⁷ *Appellants’ Jurisdictional Statement, Ball v. James*, 451 U.S. 355 (1981).

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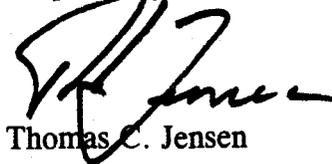
take nothing at face value and, instead, conduct your own inquiries to determine the truth about SRP. A hard look will reveal the policy and legal problems that your agencies must solve in order to frame a new policy for federal electricity in a de-regulating environment.

Don't trust-verify. SRP's complex explanations of how it allegedly complies with the simple, straightforward provisions of federal law, federal contracts, and federal and state court case law beg full investigation.

If you act, or fail to, you will be setting a critical national precedent. SRP's activities themselves are novel and unprecedented, despite SRP's assertion that its activities "are the same as those being undertaken by publicly and privately owned utilities nationally, with the endorsement and encouragement of federal, state and local regulators."¹⁸ To Tucson's knowledge, New West is the first for-profit subsidiary power marketer of a municipal entity or Reclamation project operator.

The attached memorandum responds to some of the most prominent problems in SRP's response and deserves study by your attorneys and advisors.

Respectfully,



Thomas C. Jensen

cc: Deputy Secretary Elizabeth Moler
Deputy Secretary Lawrence Summers
Solicitor John Leshy
Assistant Secretary Patricia Beneke
Associate Director T.J. Glauthier
Salt River Project General Manager

this moment. These sales are directly distorting the market by forcing Tucson and other private electricity businesses to compete with an entity selling federal electricity priced at levels that reflect significant federal subsidies.

Once competition enters the Arizona markets, this distortion will be magnified. Investor-owned utilities will then be forced to compete directly with SRP and its federally owned preference and project assets. SRP did not respond to this fundamental policy and legal concern.

b. Applicability of the Preference Clause to SRP's Power

While asking your departments to trust them to do the right thing, SRP inexplicably chooses to employ what is at best a misleading definition of a core issue, namely, how much preference power it receives.

SRP asserts that its "allocation of 'preference power' is 227 MW, which is less than five percent of SRP's total peak capacity of 5723 MW."¹ By including in this total only that power allocated to it from WAPA's hydroelectric facilities, SRP has missed the point and grossly understated its total preference power.

The real question is not how much preference power is allocated to SRP from WAPA's hydroelectric facilities, but how much of SRP's total power is governed by federal preference law and policy. That SRP would want to ask a different question is understandable; the total amount of SRP's total peak capacity subject to preference law is not "less than five percent," but is actually 4772 MW, or about 80%.² SRP's "miscalculation" springs from its failure to include its Navajo Generating Station surplus power allocation and the power generated at SRP's federal reclamation project facilities, both thermal and hydro, all of which are governed by federal preference law.³

SRP receives Navajo surplus power under three contracts with WAPA.⁴ Each of these contracts contains specific provisions indicating that SRP was selected as the contractor based on conformance with WAPA's Conformed General Consolidated Power Marketing Criteria or

¹ SRP's Response at 4 (footnote omitted).

² *Prospectus, Salt River Project Electric System Refunding Revenue Bonds, 1997 Series A, Official Statement* 16.

³ In a footnote, SRP admits that its numbers do not include SRP's contract with the Western Area Power Authority ("WAPA"), the United States Department of the Interior Bureau of Reclamation ("DOI"), and Central Arizona Water Conservation District ("CAWCD") for the Navajo Generating Station "surplus power," but offers no explanation for not including this power allocation.

⁴ *Contract No. 89-BCA-10287 Among WAPA and DOI and CAWCD and SRP For Long-Term Sale of Navajo Surplus Power*, executed May 15, 1990; *Contract No. 91-PAO-10404 Among WAPA and DOI and CAWCD and SRP For Long-Term Sale of Navajo Surplus Power*; and *Contract No. 94-PAO-10563 Among WAPA and DOI and SRP and CAWCD for Long-Term Sale of Remaining Navajo Surplus Power and Coordinated Operation of Power Systems*, executed March 15, 1994.

Regulations for Boulder City Area Projects ("Criteria").⁵ The Criteria state that the Navajo surplus power "shall be marketed and exchanged by the Secretary of Energy . . . with or through . . . entities having preference status under the preference provisions of the Reclamation Project Act of 1939."⁶ Thus, this Navajo surplus power, of which SRP received 744 MW in 1997,⁷ is no different than any other preference power received by SRP.⁸

In addition, SRP's own reclamation project facilities are governed by the preference provisions of the Act of September 18, 1922.⁹ This Act authorized the Secretary of the Interior to develop power for the Salt River Project and to sell or lease any surplus power,¹⁰ giving preference to municipal purposes. Thus, SRP's use of power from its own project facilities—3945 MW in 1997¹¹—is subject to the preference requirements. SRP completely ignores this power in its minimalist tally of SRP's total preference power.

SRP's apparent unwillingness to account fully for all allocations of or control over preference power demonstrates its inability to ensure on your agencies' behalf that the entire benefits of preference power are enjoyed by SRP's retail customers within the SRP service territory. The very fact that SRP claims only 227 MW of its available capacity as preference power underscores SRP's potential for mischief as an unregulated monopoly.

c. SRP's Unwillingness to Track Preference Power

SRP asserts that your departments should accept its word that no preference or project power benefits accrue to parties outside its traditional service territory, but simultaneously asserts that there is no way to track preference power itself. For the record, Tucson would be pleased to show your departments, or SRP, how Tucson directly tracks the power, the electrons, from one of its power plants that is governed by special federal tax-related legal restrictions. It can be done.

⁵ 49 Fed. Reg. 50582 *et. seq.* (Dec. 28, 1984); with corrections, 50 Fed. Reg. 7827 (Feb. 26, 1985).

⁶ *Id.* at 50583.

⁷ *Prospectus, Salt River Project Electric System Refunding Revenue Bonds, 1997 Series A, Official Statement* at 16.

⁸ According to the *Salt River Project Electric System Refunding Revenue Bonds, 1997 Series A, Official Statement* at 22, SRP's three contracts for Navajo surplus power give SRP a total of 744 MW of capacity. Moreover, each of the contracts specifically incorporate by reference WAPA's General Power Contract Provisions that prohibit SRP from selling power or energy supplied under the contract to a customer (e.g., New West Energy) for resale by such customer.

⁹ 43 U.S.C. § 598.

¹⁰ "Surplus" in this instance means power in excess of that needed for project irrigation pumping purposes.

¹¹ *Prospectus, supra*, at 16.

d. SRP's Violation of Preference Law

We explained in our earlier letters that SRP was violating preference law by transferring preference power, and the benefits therefrom, to its for-profit, non-preference, subsidiary and to non-preference retail and bulk-power users outside of SRP's district. SRP's marketing of its preference power in this manner deprives other preference entities of scarce and low-cost federal power that is needed to serve their traditional retail customers and places federal power in direct competition with private utilities.

SRP responds to this concern by grossly understating—by about 4500 MW—the amount of its total peak capacity subject to preference law. SRP also admits that it has no idea who actually ends up with its preference power. Although SRP asserts that it is “careful” to ensure that all the benefits of preference power are enjoyed by SRP's retail customers within its service territory, SRP does not provide the steps taken by it to ensure New West or other non-preference entities do not benefit from this federal power. Moreover, SRP does not attempt to explain how New West can supply power at rates significantly below market if it is not receiving the benefits of such power.

SRP has every incentive to ensure that its so-called “market based” sales to New West reflect the economic benefit of WAPA preference power and federal project power because New West's sale proceeds are very easily diverted to private parties (i.e., SRP Water Users). The lower the price charged by SRP to New West, the more money New West can make in California markets and elsewhere, and the more money can be diverted to SRP Water Users. There are no monitoring or auditing mechanisms in place to ensure that SRP does not convert the public benefit conferred by preference power into private benefit. At this critical juncture in the development of West Coast electricity markets, it is incumbent upon your departments to, at the very least, institute adequate monitoring mechanisms to ensure that SRP's actions comport with its promises.

Although SRP states that New West has instituted a “policy” that requires that no energy purchase from SRP be below “verifiable market prices” this alleged self-policing mechanism is wholly inadequate. What market? What price? What customers? What product? Again, your departments are being asked to take SRP uncritically at its word. SRP's promises about “the money trail” should not be countenanced. Quite simply, SRP is an unregulated monopoly flush with federal assets.

Finally, SRP does not contest that the federal regulations forbid it from reselling preference power for a profit to any customer for resale by that customer.¹² SRP's admission in its response that it is selling power to New West under a market-based methodology suggests that it is violating this bedrock regulatory mandate.

¹² 49 Fed. Reg. 50582, 50585 (1984).

In its response, SRP cites *Greenwood Utilities Comm'n v. Hodel*¹³ and *Brazos Electric Power Cooperative, Inv. v. Southwestern Power Administration*¹⁴ as supporting its position. In fact, both of these cases are contrary to SRP's stance. *Greenwood* and *Brazos* stand primarily for the proposition that *only* in the very limited circumstance when transmission by a non-preference entity is required for a preference entity to receive power, a non-preference entity can receive a small amount of preference power as compensation for the services provided. SRP's transfer of preference power benefits to New West does not fall within this limited exception and therefore violates federal preference law.

SRP's reference to *Greenwood* and *Brazos* as directly supporting the proposition that "preference power is administered by tracking benefits, not electrons" leaves the reader with the distinct impression that SRP needed some legal "window dressing" for its letter without bothering to read the cases.

Greenwood involved an attempt by the electric supply agency of the City of Greenwood, Mississippi ("Greenwood") to purchase preference power from the Southeastern Power Administration ("SEPA"). Greenwood sought both an allocation of power from current SEPA allocations among preference customers, and an additional allocation to compensate it for power it alleged should have been allocated in the past. The Court held that the retroactive allocation claim was in effect a claim for monetary damages for which sovereign immunity had not been waived, and equitable considerations prevented the Court from redistributing previously committed power. Moreover, the Court held that judicial review of SEPA's allocations among preference customers is not available because there is no law to apply to SEPA's decision and, accordingly, such decisions are committed to agency discretion as a matter of law. As to Greenwood's claim for a then-current allocation of preference power, the Court held that SEPA's allocation to Greenwood under a new marketing plan rendered the claim moot. Greenwood argued that despite its allocation under SEPA's new marketing plan, SEPA was still violating the preference clause because certain non-preference electric utility entities were receiving preference power benefits in return for providing transmission wheeling and firming services. The Court pointed to the fact that SEPA owns no transmission facilities and that the benefits received by the non-preference entities were appropriate compensation for the necessary transmission and firming services provided by the non-preference entities.¹⁵

In *Brazos Electric Power Coop. v. Southwestern Power Admin.*,¹⁶ the Court addressed Brazos' claim that the Southwestern Power Administration ("SWPA") failed to comply with the preference clause by indirectly marketing preference power to an investor-owned utility, Texas

¹³ 764 F.2d 1459 (11th Cir. 1985).

¹⁴ 828 F.2d 1082 (5th Cir. 1987).

¹⁵ In fact, the non-preference entities were receiving capacity, with no energy, that could not be used by the preference customers.

¹⁶ 819 F.2d 537 (5th Cir. 1987).

Utilities Electric Company ("TUEC"), when that power was otherwise only available to preference customers.¹⁷

The SWPA sold the preference power in question to Tex-La and Rayburn County, two preference entities. TUEC, who owned the only transmission lines capable of delivering the preference power to the preference customers, acted as the scheduling agent for the two cooperatives. As such, TUEC received the cooperatives' hydroelectric power and associated energy for transmission, scheduling, and firming. In return for these services, TUEC received 5% of the energy handled and, as a result, became the recipient of a portion of the preference power allocated to the preference entities. Arguing that it was entitled to this power as a preference entity, Brazos challenged the transfer of power to TUEC as a violation of the preference clause.

In rejecting Brazos' challenge, the Fifth Circuit explained that the arrangement in question had long been used by preference customers without transmission lines and had been authorized by the SWPA. Without such arrangements, the preference entities could not acquire their power allocation. The Court concluded that allowance to TUEC of a small portion of the energy handled as compensation for its transmission, scheduling, and firming services was not a prohibited sale to a non-preference customer. However, the Fifth Circuit counseled that the value of power given as a quid pro quo for services must be reasonable and consistent with the value of the necessary services rendered the preference customer.

The Fifth Circuit therefore approved the transfer of preference power to a non-preference entity in the limited case where that transfer was reasonable consideration for the transmission, scheduling, and firming of a preference entity's power allotment.

In contrast to the benefits received by non-preference entities in the *Greenwood* and *Brazos* cases, SRP's transfer of preference power benefits to a for-profit subsidiary, New West, are not reasonable compensation for necessary transmission, scheduling, and firming of a preference entity's power allotment. Moreover, the *Greenwood* and *Brazos* cases are wholly inapplicable to preference allocations from WAPA because, unlike SEPA and SWPA, WAPA owns transmission facilities. Thus, the reasoning in *Greenwood* and *Brazos* supports, rather than undermines, Tucson's position that SRP's transfer of preference power benefits to New West Energy violates the plain meaning and purpose of the preference clause.

SRP is transferring preference power and its economic benefit to New West. New West is reselling that power to private parties. It seems clear that WAPA could not sell preference power, except under extraordinary circumstances, to either New West or its customers. It cannot be legal, and it certainly is not sound policy, for your departments to allow SRP to do indirectly what WAPA is prohibited from doing directly.

¹⁷

Id. at 539.

e. SRP's Violation of Reclamation Law

We also expressed our concern that the extent and nature of SRP's power activities violate federal Reclamation law because SRP's power business is no longer incidental to irrigation, but has in fact become SRP's predominant purpose. Indeed, SRP quotes its FY 1997 power revenues at \$1.446 billion, or 99.3% of total revenues, and its water revenues at only \$11.5 million, or 0.7% of total revenues. SRP did not respond to this concern.

In addition, we also pointed to Reclamation law's prohibition on the distribution of power revenues as profits.¹⁸ Because SRP's power profits are being used to subsidize water prices for private landowners, SRP is apparently violating this prohibition. SRP does not directly respond to this concern.

SRP does assert that its constituents cannot be analogized to private shareholders, and that the true beneficiary of SRP's power sales is the general public of Central Arizona. This assertion is contradicted by SRP's own statements as well as the United States Supreme Court's characterization of SRP. In *Ball v. James*,¹⁹ the Supreme Court noted: "As repeatedly recognized by the Arizona courts, though the state legislature has allowed water districts [such as SRP Power District] to become nominal public entities in order to obtain inexpensive bond financing, the districts essentially remain business enterprises, created by and chiefly benefiting a specific group of landowners." In 1981, moreover, SRP itself argued that it is "virtually indistinguishable from any other utility operated for the benefit of its owners."

f. SRP's Violation of Federal Property Law

In our earlier letter, we expressed our concern that SRP is privatizing federal property through New West Energy and other SRP-sponsored businesses. The United States, through the Interior Department, is the ultimate owner of SRP's power facilities and project power and thus has a direct interest in the use of the facilities and disposition of that power. The Interior Department, as well as the Energy Department, have general supervisory powers over SRP. Because of this ownership and supervisory authority, your Departments have a significant stake in ensuring that SRP and its affiliates do not profit from the privatization of federal property at the expense of competition.

Federal property management law requires prior approval of a sale of government property,²⁰ with proceeds to go to the United States Treasury.²¹ That law further provides that agencies

¹⁸ 16 U.S.C. § 825t (1985).

¹⁹ 451 U.S. 355, 367.

²⁰ 48 C.F.R. § 45-610-1(a) (1997).

²¹ 48 C.F.R. § 45-610-3 (1997).

“[e]liminate to the maximum practical extent any competitive advantage that might arise from using such property.”²²

Although SRP’s response initially acknowledges the United States’ interest in SRP’s assets and operations, it proceeds to disclaim the United States’ ownership interest with the following statement: “SRP’s assets are not ‘government property’ within the meaning of [federal property] laws. The regulations define ‘government property’ as ‘all property owned by or leased to the Government,’ which is not applicable to SRP.”²³ Not only is this statement contrary to law and without support, it directly contradicts numerous statements made previously by SRP. In 1966, SRP told the Arizona Supreme Court that “the United States is either the owner of all of the properties comprising the Salt River Project, or has a direct and definite interest therein.”²⁴ In 1981, SRP stated that “[s]ince it is a federal reclamation project, title to many of the Salt River Project properties vested in the United States,”²⁵ and just last year, SRP again confirmed the United States’ “paramount right or claim” in the Project.²⁶

SRP apparently suggests that the Interior Department’s property interest and supervisory authority has been forfeited by a 1972 Interior Department memorandum which waived review of SRP’s power-sales contracts by that Department. This waiver (which the Interior Department may reverse as a matter of policy) applies only to a single ministerial step and does not limit the supervisory authority or the basic property interest of the federal government. Only Congress can transfer Reclamation project title; it does so rarely and has not done that here. Once again, the suggestion that this Nixon-era memorandum compromises the United States’ ownership of or supervisory authority over SRP is contradicted by SRP’s own express reaffirmation just last year of the United States’ ownership interest²⁷ and its supervisory authority over SRP’s power rates.²⁸ Everything SRP asserted in its briefs in the *City of Mesa v. SRP* case regarding the federal purpose of the project, and federal ownership, remains true today – no matter how uncomfortable it is to SRP to be reminded of it.

²² 48 C.F.R. § 45.102(a).

²³ Letter from Kenneth C. Sundlof, Jr., attorney, Jennings, Strouss & Salmon, P.L.C. to Secretaries Babbitt, Peña, Rubin and Director Raines (Mar. 2, 1998) (citation omitted).

²⁴ *Brief of Appellee SRP, City of Mesa v. Salt River Project Agricultural Improvement and Power District*, 416 P.2d 187 (Ariz. 1966) 31.

²⁵ *Jurisdiction Statement of Appellant SRP, Ball v. James*, 451 U.S. 355 (1981).

²⁶ *Salt River Project Electric System Refunding Revenue Bonds, 1997 Series A*, October 1, 1997.

²⁷ *Id.* at 8.

²⁸ *Id.* at v.

g. SRP's Inadequate Self-Regulation

Even if SRP made the principled decision to isolate and not compete with the benefits it receives from the federal government, there is no regulatory oversight or adequate firewall in place to ensure that this will necessarily be the case. SRP is unregulated. Its for-profit power marketing subsidiary is unregulated (although SRP states incorrectly that New West is a "fully regulated entity").²⁹

The SRP corporate family has argued that there is no "mark-up" of preference power because SRP is established for the public's purpose and benefit. This assertion is wholly incorrect. By its own admission, and as found by the United States Supreme Court in *Ball*, SRP functions as a private utility.³⁰

SRP's novel corporate arrangement permits it to generally conduct a shell game with the costs and benefits of water and power production. Because SRP Water Users, a private corporation, is the alter ego and creator of the SRP Power District,³¹ it is entirely possible—intended, in fact—for SRP Power District to pass on electricity ratepayer benefits to SRP Water Users' shareholders (*i.e.*, Salt River Valley private landowners). Thus, it appears to Tucson that, for years, WAPA preference power has been resold by SRP at retail and wholesale, and that profits made from such resale are diverted to SRP Water Users, a private corporation. Indeed, unlike legitimate municipal preference agencies, it appears to Tucson that a private corporation has been directly profiting from the resale of WAPA preference and project power.

With the creation of New West, the inappropriate situation is exacerbated further. Your departments have no way of knowing whether any financial benefits obtained by New West will be credited to SRP Power District electricity ratepayers. In fact, even though SRP promises otherwise, there is no way of knowing whether an arrangement has been established between New West and SRP Water Users which will pass all financial benefits on to SRP Water Users directly.

h. SRP's Divergence from the Intent of Preference Policy

In our earlier letter, we proposed that you consider whether the true substance of SRP's business had grown too attenuated from the bases that would justify continued access to federal power

²⁹ We are not sure how SRP overlooked the material fact that less than two months ago the Federal Energy Regulatory Commission issued an order refusing to assert jurisdiction over either New West or SRP itself. 81 FERC ¶ 61,416 (1997).

³⁰ *Ball*, 451 U.S. at 367 (citations omitted)(emphasis added).

³¹ SRP Power District and SRP Water Users and New West Energy have interlocking boards of directors. *Annual Report* at 30. SRP Power District has 14 board members, 10 of whom also comprise the entire board of SRP Water Users. In short, as a result of common control, SRP Water Users and SRP Power District and New West effectively act as one and the same entity. New West's board and officers are all identical to those of the SRP Power District.

benefits. SRP did not respond to this concern. It may be helpful to review the simple boundaries that were established in the early years of the preference program.

Preference for public entities over private entities in the allocation of federal power “has been a basic tenet of governmental policy since 1906 when the Congress first authorized power developments on Reclamation projects.”³² Congress inserted preference clauses in the Reclamation laws to ensure that low-cost federal power went to nonprofit, public entities and their members. The public purpose of power preference was to avoid private monopolization of valuable hydropower developed from the public’s waterways and to boost rural electrification and development. The government was obliged to give certain parties preference in the sale of its power, but that preference did not translate to a federal preference for certain fortunate entities in competitive power markets. SRP’s activities are transforming their preferential access to federal power into a preferred position in competitive markets. That seems clearly beyond the intent of the preference law and policies.

These themes are amplified in the legislative history of several of the Reclamation acts. For instance, the Senate Committee on Commerce reported on the Flood Control Act of 1944’s preference clause³³ as follows:

The committee desires an amendment which provides convenient and practical method of disposing of power . . . without setting up a public power trust which would be unduly competitive with established private power utilities.³⁴

Congress echoed these sentiments in a House Report accompanying the Bonneville Project Act of 1937:

³² 90 Cong. Rec. 8315 (1944) (Letter from Interior Secretary Ickes to Senator Barkley).

³³ Although the source of authority for SRP’s power development is the Reclamation Act of 1906, and not the Flood Control Act—which was directed toward Department of Army projects, WAPA does “as a matter of policy give effect to the [Flood Control Act’s preference clause] in developing power marketing programs.” 51 Fed. Reg. 4847. In addition, courts have found the Flood Control Act’s preference provision applicable to projects not under the control of the Department of Army. See, e.g., *Brazos Electric Power Coop. v. Southwestern Power Auth.*, 819 F.2d 537, 543-544 (5th Cir. 1987), *Salt Lake City v. Western Area Power Auth.*, No. C86-1000G, 1988 U.S. Dist. LEXIS 16822, *30-31 (D. Utah Apr. 14, 1988), *aff’d*, 926 F.2d 974 (10th Cir. 1991). Moreover, when examining the meaning of a particular preference clause, the US Attorney General and others have read all of the reclamation acts and their legislative history together in determining the clause’s meaning. See 41 Op. Atty Gen. 236 (July 15, 1955) (“Since each of these statutes deals with the preferential disposition of Federal Power, they should be read *in pari materia* to ascertain the intent of Congress. . . . It is clear that [Congress, in incorporating the preference clause in the Flood Control Act of 1944,] wished generally to continue the policies it had theretofore formulated in other power acts.”); Jeffrey C. Fereday, Comment, *The Meaning of the Preference Clause in Hydroelectric Power Allocation under the Federal Reclamation Statutes*, 9 Environmental Law 601, 619 (1979) (stating that the 1933-38 power-type reclamation laws “provide the basis for the present state of the law with respect to the meaning, effect and purpose of the preference clauses” and “as a matter of both practicality and proper legal interpretation, the preference clauses of all the reclamation laws together describe a single preference policy”).

³⁴ Sen. Rep. No. 1030.

[T]he electrical energy . . . shall be sold at wholesale under contracts with the States and political subdivisions of States, including counties, municipal corporations, and utility districts, and so-called power districts, and to cooperative organizations of citizens which are not organized to do business for profit, but for the major and primary purpose of supplying electrical energy to their members as nearly as possible at actual cost.³⁵

Several years after passage of the Flood Control Act, the Department of Interior reiterated before Congress its commitment to operate federal generating facilities for the benefit of the general public, consistent with the preference concept:

The Department of the Interior will operate the federally owned generating and transmission facilities under its control for the benefit of the general public, and particularly of domestic and rural customers, and the Department will give preference and priority to public bodies and cooperatives in disposing of electric energy generated at Federal plants. It will be the policy of the Department to dispose of power, remaining after the provision for existing preference customers, to privately owned public utilities serving domestic and rural customers in the area.³⁶

As this history and the language of the preference clauses suggest, those preference entities demonstrating a need to serve its members should receive priority in the allocation of power generated through federal reclamation projects. Congress intended that the power received by these entities was to serve the needs of the general public by providing a valuable commodity at the lowest possible price -- and not at a profit. More important, however, Congress never intended that preference entities would use their federal subsidies to compete unfairly with private utilities. By turning itself into, for all meaningful purposes, a for-profit power company delivering financial rewards directly to private shareholders, SRP has become the very entity that the preference policy was intended not to benefit.

III. Conclusion

SRP's response is no answer to the substantial legal and policy issues we have asked you to address. Instead, they offer another round in the long-running shell game. We ask you to watch the pea, not the hands.

The federal government owns the power and project at issue. Your property is being used to compete directly with private businesses. The situation is unfair, unnecessary, and illegal.

³⁵ H.R. Rep. No. 2955, 74th Cong., 2d Sess. 3 (1937).

³⁶ Power Policy Statement of August 1953 (printed at pp. 333-337 of Power Policy Hearings (1953) before Subcommittee of the Senate Judiciary Committee, 83d Cong., 1st Sess.).

The problem is bad now and, if you do not act, it is going to get much worse as Arizona and other states deregulate the electricity business.

We believe that what SRP is doing is illegal and against sound public policy. We urge you to investigate and act now.



...utilities exceeds \$31 billion, in 1996 dolla
...cost to decommission reactors owned by the

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ABOUT PDF

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Salt River may be
selling a portion of
its preference power

Thursday, March 5, 1998

Public Power's Role in Open Markets Questioned in Southwest

**Salt River Project's Use of Federal
Power Supplies Questioned**

Marketing Effort Paying Off in California

**Low-Cost Power, Low Rates Provide
Competitive Boost**

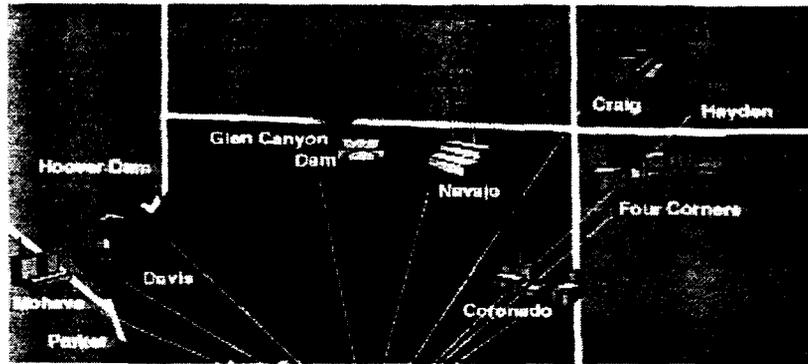
Arizona may soon be a focus in the debate over what constitutes the proper use of federal assets in a deregulated industry. Tucson Electric Power and the Salt River Project are battling over Salt River's apparent intention to compete for retail customers in California. How this local confrontation is resolved may have implications for the nation's public power sector as a whole.

Like other public power enterprises, Salt River is considered a "preference" customer in securing power produced at federally owned facilities, including the Western Area Power Administration (WAPA) and Bonneville Power Administration. Part of the controversy surrounds whether or not Salt River may be selling a portion of its preference power to third parties, who are not entitled to receive this power.

Salt River Project's Sources of Electricity

to third parties

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CLICK ON MAP TO VIEW FULL IMAGE

“
Salt River's
transmission system
links its plants and
retail markets with
several other outside
markets.

”

The issue is less than clear-cut. For example, Salt River may have been selling surplus capacity/energy available on the market. Or, because preference allocations of hydroelectric capacity are based on low water years, and since the recent past includes several above-normal hydro years, Salt River may have been selling surplus hydro energy and not "preference" energy. Indeed, Salt River has been quoted in recent news reports as saying that only 3% to 5% of its generation mix is federal preference power. Sorting out the issue will be no easy matter.

A Pivotal Player

Salt River plays a pivotal role in Arizona electric markets. Salt River, along with Arizona Public Service, provide electric service to the greater Phoenix

metropolitan area. Population growth across the area has continued to drive increased retail sales. Beyond that, Salt River's transmission system links its plants and retail



Source: State of Arizona

markets with several other outside markets, including soon-to-be-deregulated markets in southern California. Depending on how the Tucson Electric dispute is resolved, soon-to-open California retail markets may offer promising growth opportunities for Salt River Project.

State-Owned Enterprise, Power from Federal Facilities

Salt River began as an outgrowth of federal efforts to

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Residential and commercial customers dominate Salt River's retail sales picture.

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TVA drew fire from regulators last year when it attempted similar wholesale transactions.

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Tucson Electric suggests that Salt River be required to divest its generating resources.

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manage water resources in the Southwest. It now provides electric power and water services, and owns and operates electric generation resources. Salt River actually is a political subdivision of the state of Arizona, and many of the generation resources it relies on are owned by the federal government property, which Salt River uses through contract agreements.

Growing Arizona Retail Market, Emerging Wholesale Presence

Salt River is a formidable presence in Arizona's electric markets. During 1996, Salt River served over 628,000 retail customers and sold over 24 million MWh of electricity, with over 18 million MWh sold to retail customers. Residential and commercial customers dominate Salt River's retail sales picture, accounting for 42% and 34% of its total sales, respectively. Retail sales for all customer classes rose by as much as 20% between 1993-1996. These increases reflect the robust economic growth occurring in the area surrounding Phoenix.

Overview of Operations, 1993-1996

On top of the solid gains in retail markets, Salt River expanded its wholesale market presence 58% between 1993-1996. Wholesale sales rose most dramatically from 1993-1994 when they increased nearly 66%. During 1996, Salt River sold wholesale power to several power marketers, including Duke/Louis Dreyfus, LLC; Electric Clearinghouse, Inc.; Enron Power Marketing, Inc.; and, Vitol Gas & Electric, L.L.C. (Catex Vitol). The Tennessee Valley Authority, which is a federal rather than a state entity, drew fire from regulators last year when it attempted similar wholesale transactions.

California Market Shares

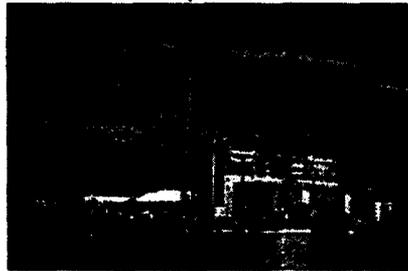
The current controversy surrounds Salt River's New West Energy unit, which was formed to compete in deregulating retail power markets. Already, New West has announced an agreement to supply power to several California businesses and is marketing an array of services to California customers. These marketing efforts were the subject of complaints filed by Tucson Electric with the departments of Interior, Energy and Treasury.

Tucson Electric's complaint alleges that New West Energy's retail marketing efforts will result in an unauthorized use of subsidized federal power for profit. As far as suggested remedies, Tucson Electric suggests as one option that Salt River be required to divest its generating resources or sell any excess power at public auctions. Such a remedy, if ultimately adopted and used as a precedent for other federal power recipients, could dramatically alter the nation's power landscape.

A Growing Reliance on Wholesale Sources

Salt River relies on its own generation resources and wholesale purchased power to meet most of its power supply requirements. During 1996, Salt River generated 71% of its total sources of power and purchased the remainder. As recently as 1993, Salt River generated 90% of its requirements.

During 1996, Salt River owned nearly 4,000 MW of generating capacity, including coal and natural gas-fired plants as well as hydroelectric and nuclear stations. As part of that array, Salt River owns part of,



Coronado Generating Station

Source: Salt River Project

or has an interest in, several of the largest generating stations across the Southwest, including the Navajo, Four Corners (units 4&5), Mohave, Hayden, Craig and Palo Verde generating stations.

During 1996, these plants operated at relatively high capacity factors, ranging from 73% at Mohave to 88% at Craig's #1-2 units.

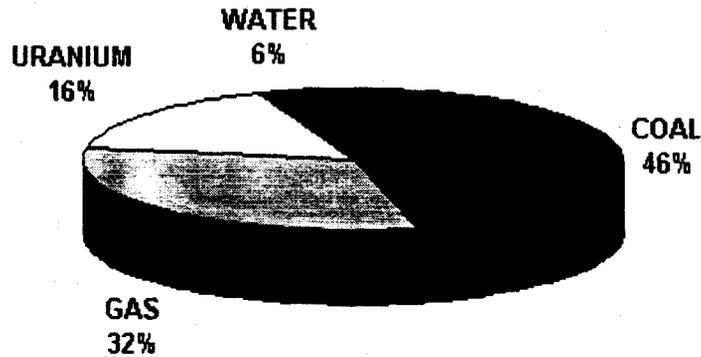
These highly productive plants are complemented by the coal-fired Coronado plant, by a collection of smaller hydroelectric stations, and by several natural gas-fired plants. In general, Salt River's natural gas-fired units operate at relatively low capacity factors, providing power primarily during peak periods. During 1996, Salt River's generating portfolio included 46% coal-fired, 32% natural gas-fired, 16% nuclear and 6% hydroelectric. In terms of generation during 1996, Salt River used coal-fired plants (68% of total net generation) and nuclear stations (28% of total net generation).

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Salt River bought
over 2.7 million
MWh from WAPA.

Capacity Portfolio, 1996

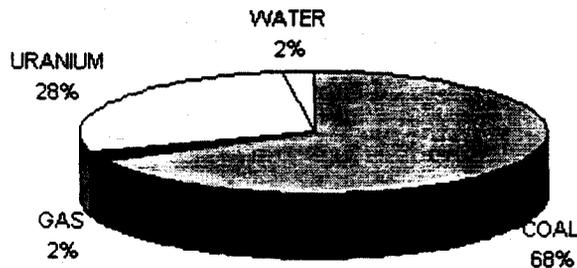
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Salt River is well positioned to influence local wholesale power markets.
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Source: POWERdat

Generating Mix, 1996



Source: POWERdat

Like other public power enterprises, Salt River is considered a "preference" customer in securing power produced at federally owned facilities, including WAPA and Bonneville Power Administration. In total, Salt River bought over 2.7 million MWh from WAPA and over 350,000 MWh from BPA during 1996.

Salt River has purchased power from several hydroelectric facilities, including Glen Canyon. (In an effort to mitigate environmental damages identified in a recent Environmental Impact Statement, WAPA may be forced to lower the availability of hydropower from Glen Canyon in coming years.) In addition, Salt River has an agreement with WAPA to trade power generated at the Four Corners station for power generated at Glen Canyon. The arrangement is designed to lessen the need for transmission upgrades for both entities. Salt River also has agreements to secure 744 MW of capacity from the Hoover Power Plant, New Waddell Dam and Navajo Generating Station with the United States Bureau of Reclamation, the Central Arizona Water Conservation District and WAPA.

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Salt River's rates were significantly below those charged by Arizona's investor-owned

Low Energy Costs

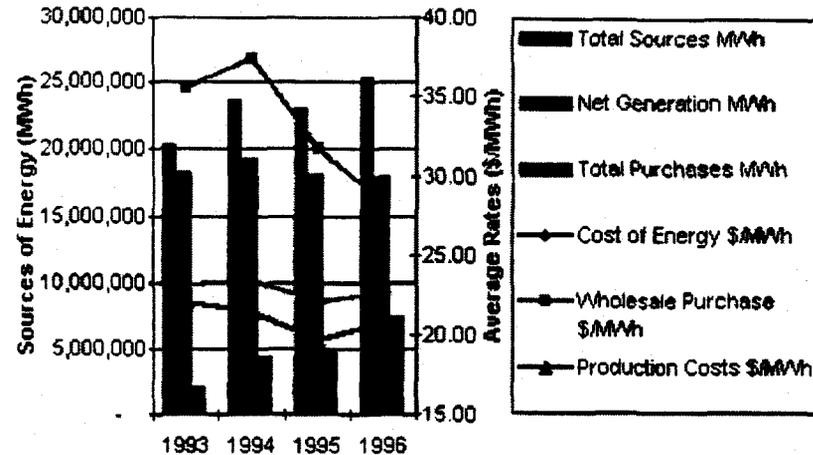
With an overall cost of energy under \$23/ MWh during 1996, Salt River is well positioned to influence local

utilities.

”

wholesale power markets. Low and declining costs of production have boosted its competitive position. During 1996, for example, Salt River's average cost of production was \$20.78 /MWh, down 6% since 1993.

Sources and Costs of Power Supply, 1993-1996



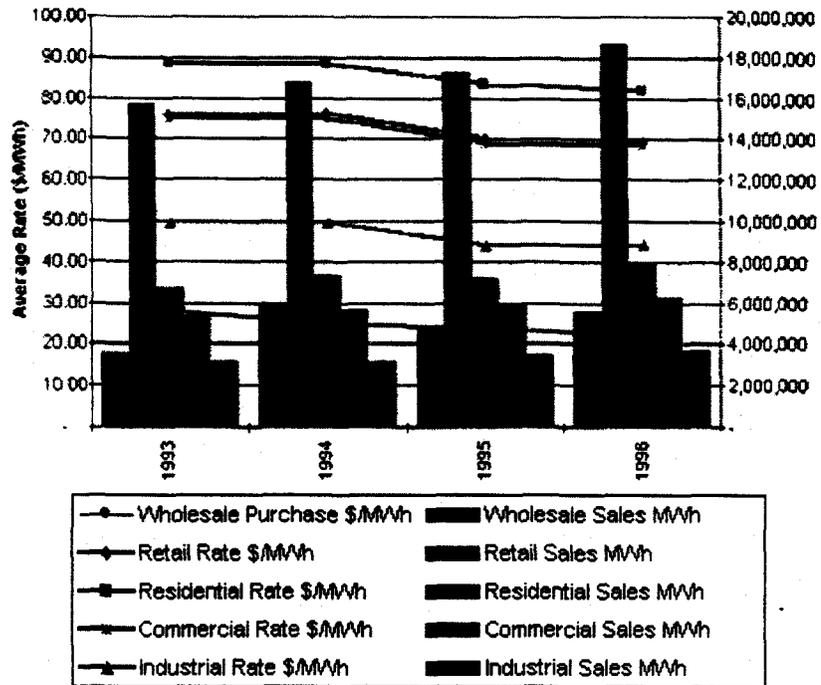
Source: POWERdat

Salt River's wholesale power costs also declined 20% over the period, largely driven by increases in purchases of low-cost power from WAPA. These purchases increased by more than 2 million MWh from 1993-1996, allowing Salt River to increase its energy supplies without the adding capacity or increasing output at its more expensive natural gas-fired plants.

Retail Rates Among the Lowest in Arizona

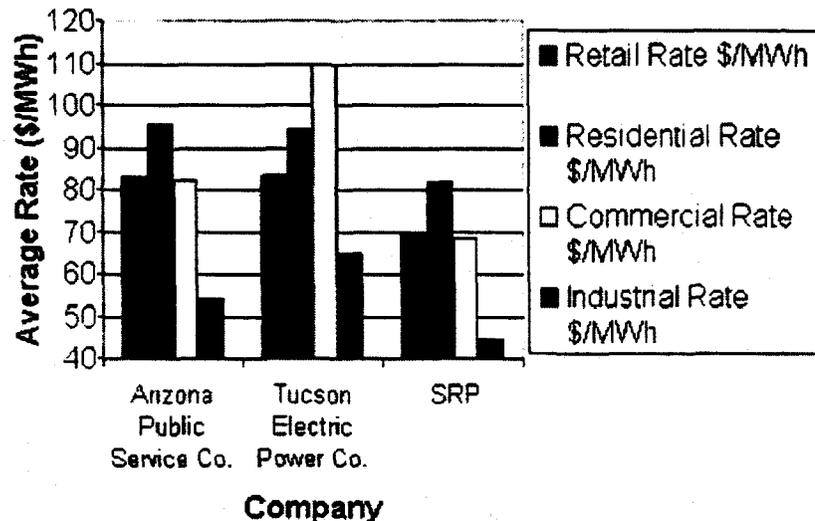
Due in part to its low cost of energy, Salt River charges retail customers relatively low average rates. During 1996, overall retail rates averaged \$69.42 /MWh, although these were not evenly distributed across customer classes. Residential customers' rates were 185% of the average rates paid by industrial customers. Residential rates averaged \$81.68 /MWh during 1996, commercial rates averaged \$68.62 /MWh and industrial rates averaged \$44.26 /MWh. In each case, Salt River's rates were significantly below those charged by Arizona's investor-owned utilities.

Sales and Average Rates, 1993-1996



Source: POWERdat

Average Rates, 1996



Source: POWERdat

Sorting out the issues in the current controversy will no doubt be a difficult undertaking. How the dispute ultimately is settled may have consequences that reach well beyond the Southwest.

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Beginning of Story

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Thursday, March 5, 1998

U.S. Utilities Bid On 320 MW Power Supply Contract To Mexico

LOS ANGELES (Dow Jones)--About a dozen U.S. utilities and power marketers and one Canadian concern have submitted bids to Mexico's government-owned electricity monopoly, Comision Federal de Electricidad, to supply 320 megawatts of electricity to the Baja California region during peak demand times.

Baja California is an electricity-starved, peninsula-shaped region along Mexico's northwestern coast which is desperate for power during peak periods due to the maquiladora growth near the border. Maquiladoras are foreign-owned plants in Mexico that make products for export and are set up to take advantage of Mexico's low labor costs. Most of them are located on or near the U.S. border.

Industry sources said a dozen U.S.-based utilities are vying for the contract to supply electricity over a six-month period from May to October. The deadline to submit bids was March 3, the sources said.

The sources identified at least 10 firms. These companies include Arizona Public Service Co., the electric utility unit of Pinnacle West Capital Corp. (PNW); Enova Corp.'s (ENA) Sempra Energy Trading unit; Enron Corp. (ENE); the Imperial Irrigation District, a public water agency in California looking to get into electricity sales; Los Angeles Department of Water and Power; PacifiCorp (PPW); Powerex, the electricity trading arm of Canada's B.C. Hydro; Public Service Co. of New Mexico (PNM); Salt River Project; and, U.S. Generating Co., a unit of PG&E Corp.'s (PCG) Pacific Gas & Electric Co. utility.