

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



OPEN MEETING ITEM

JACK ROSE
EXECUTIVE SECRETARY

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ARIZONA CORPORATION COMMISSION

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DATE: MAY 6, 1998
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TO ALL PARTIES:

Arizona Corporation Commission

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APR 06 1998

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Enclosed please find the recommendation of Hearing Officer Jerry Rudibaugh. The recommendation has been filed in the form of an Opinion and Order on:

COMPETITION OF ELECTRIC SERVICES THROUGHOUT THE
STATE OF ARIZONA
(ELECTRIC COMPETITION)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Hearing Officer by filing an original and ten (10) copies of the exceptions with the Commission's Docket Control at the address listed below by 4:00 p.m. on or before:

MAY 15, 1998

The enclosed is NOT an order of the Commission, but a recommendation of the Hearing Officer to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Working Session and Open Meeting to be held on:

MAY 19, 1998 and MAY 20, 1998

For more information, you may contact Docket Control at (602)542-3477 or the Hearing Division at (602)542-4250.

Jack Rose
JACK ROSE
EXECUTIVE SECRETARY

1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

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

8 IN THE MATTER OF THE COMPETITION IN)
9 THE PROVISION OF ELECTRIC SERVICES)
10 THROUGHOUT THE STATE OF ARIZONA.)

DOCKET NO. RE-00000C-94-0165

11 DECISION NO. _____

12 **OPINION AND ORDER**

13 DATES OF HEARING:

December 9, 1997 and February 5, 1998 (Procedural
Conferences); February 9, 10, 11, 12, 13, 17, 18, 19, 20,
23, 25, 26 and 27, 1998

14 PLACE OF HEARING:

Phoenix, Arizona

15 PRESIDING OFFICER:

Jerry L. Rudibaugh

16 IN ATTENDANCE:

Renz D. Jennings, Commissioner
Carl J. Kunasek, Commissioner

17 APPEARANCES:

18 Mr. Steven M. Wheeler, Mr. Thomas L. Mumaw and Mr.
19 Jeffrey B. Guldner, SNELL & WILMER, LLP, on behalf
20 of Arizona Public Service Company;

Ms. Deborah R. Scott and Ms. Teena Wolfe, on behalf of
the Residential Utility Consumer Office;

Mr. Raymond S. Heyman, ROSHKA, HEYMAN &
DEWULF, P.C., and Mr. Bradley S. Carroll, on behalf of
Tucson Electric Power Company;

Mr. Craig A. Marks, on behalf of Citizens Utilities
Company;

Mr. Lex J. Smith, BROWN and BAIN, P.A., on behalf of
Ajo Improvement Company, Morenci Water and Electric
Company, and Phelps Dodge Corporation;

Mr. Michael M. Grant, GALLAGHER & KENNEDY, on
behalf of Arizona Electric Power Cooperative, Graham
County Electric Cooperative, and Duncan Valley Electric
Cooperative;

Mr. Walter W. Meek, President, on behalf of Arizona
Utility Investors Association;

Mr. Norman J. Furuta, on behalf of the Department of the
Navy;

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Ms. Betty Pruitt on behalf of Arizona Community Action Association;

Mr. C. Webb Crockett and Mr. Jay L. Shapiro, FENNEMORE CRAIG, on behalf of Cyprus Climax Metals, Co., ASARCO, Inc., and Arizonans for Electric Choice and Competition;

Mr. Robert S. Lynch on behalf of Arizona Transmission Dependent Utility Group;

Mr. Douglas C. Nelson and Mr. Michael B. Day, GOODIN, MACBRIDE, SQUERI, SCHLOTZ & RITCHIE, LLP, on behalf of Electric Competition Coalition, Enron Corporation and Enron Energy Services, Inc.;

Mr. Lawrence V. Robertson, Jr., MUNGER CHADWICK, on behalf of PG&E Energy Services and Arizona School Boards Association;

Ms. Barbara Sherman and Ms. Marcia Weeks on behalf of Arizona Consumers Council;

Ms. Suzanne M. Dallimore, Antitrust Unit Chief, on behalf of the Arizona Attorney General's Office;

Ms. Loretta Humphrey, Civil Division, on behalf of the City of Tucson;

Mr. William P. Sullivan, MARTINEZ & CURTIS, P.C., on behalf of Navopache Electric Cooperative;

Ms. Elizabeth S. Firkins on behalf of International Brotherhood of Electrical Workers, L.U. #1116;

Mr. Carl Dabelstein in pro persona;

Mr. Myron L. Scott on behalf of Arizonans for a Better Environment;

Mr. Andrew W. Bettwy on behalf of Southwest Gas Corporation; and

Mr. Paul A. Bullis, Chief Counsel, Mr. Christopher C. Kempley, Assistant Chief Counsel and Ms. Janice M. Alward, Staff Attorney, on behalf of the Utilities Division of the Arizona Corporation Commission.

BY THE COMMISSION:

The Arizona Corporation Commission ("Commission") issued Decision No. 59943, dated December 26, 1996, which approved new rules, A.A.C. R14-2-1601 through R14-2-1616 ("Rules" or "Electric Competition Rules"). On August 29, 1997, the Commission issued Decision No. 60351, in which the Hearing Division was directed "to produce procedural orders in order to establish hearings, evidentiary or otherwise, regarding any aspect of electric competition that is necessary and appropriate."

On October 30, 1997, the Residential Utility Consumer Office ("RUCO") filed a Request for Evidentiary Hearing and Procedural Order ("Request for Hearing"). On November 21, 1997, Tucson Electric Power Company ("TEP") filed a Response in support of RUCO's Request for Hearing. On November 21, 1997, Citizens Utilities Company ("Citizens") filed a Statement in support of RUCO's Request for Hearing.

On November 13, 1997, ASARCO Incorporated, Cyprus Climax Metal Corporation and Enron Corporation filed their Objection to RUCO's Request. On November 15, 1997, the Electric Competition Coalition filed its Objection to RUCO's Request.

The Electric Competition Rules created several working groups that were required to generate reports regarding various aspects of the transition to competition. On September 30, 1997, the Stranded Cost Working Group ("Group") filed its Report with the Commission. The Group provided an oral presentation to the Commission on November 25, 1997.

Pursuant to Decision No. 60351 and A.A.C. R14-3-109, our December 1, 1997 Procedural Order set an evidentiary hearing on generic issues related to stranded costs and scheduled a December 9, 1997 Procedural Conference. The following were participants in the December 9, 1997 Procedural Conference and were designated as parties in this matter:

Arizona Electric Power Cooperative ("AEPSCO")
 Arizona Community Action Association ("ACAA")
 Ft. Huachuca ("FTH")
 State of Arizona, Attorney General's Office ("Attorney General")
 Safford, Wickenburg Irrigation & Electric District
 Salt River Project Agricultural Improvement and Power District ("SRP")¹
 Irrigation and Electrical District of Arizona
 PG&E Energy Services ("PG&E")

¹ Subsequently, SRP withdrew from the proceeding.

1 Arizona Utility Investors Association ("AUIA")
 2 Morenci Water & Electric., Ajo Improvement Co ("Morenci" and "Ajo")
 3 Residential Utility Consumer Office
 4 Citizens Utilities Company
 5 City of Tucson
 6 Arizona Public Service Company ("APS")
 7 Tucson Electric Power Company
 8 Cyprus Climax Metals Co. ("Cyprus")
 9 Electric Competition Coalition
 10 Arizonans for Electric Choice and Competition
 11 Enron Corporation ("Enron")
 12 ASARCO Incorporated
 13 Staff of the Arizona Corporation Commission ("Staff")

14 The following additional entities requested and were granted intervention:

15 Goldwater Institute
 16 Land and Water Fund
 17 Mohave Electric Cooperative, Inc.
 18 Navopache Electric Cooperative, Inc.
 19 Arizona Consumers Council
 20 BHP Copper, Inc.
 21 Mr. Carl Dabelstein
 22 Arizona Municipal Power Users' Association
 23 City of Phoenix
 24 Arizonans for a Better Environment
 25 Arizona Transmission Dependent Utility Group ("Utility Group")
 26 Southwest Gas Corporation
 27 Trico Electric Cooperative, Inc.
 28 Sulphur Springs
 Graham County Electric Cooperative, Inc.
 Duncan Valley Electric Cooperative, Inc.
 City of Scottsdale
 Arizona School Boards Association ("School Board")
 PacificCorp
 Center for Energy and Economic Development
 International Brotherhood of Electrical Workers ("IBEW")
 Phelps Dodge
 Department of the Navy on behalf of the Department of the Defense ("Department of Defense")

1 The following parties appeared and presented evidence at the hearing: Citizens; ACAA; IBEW;
 2 TEP; Enron; City of Tucson; Department of Defense; PG&E; Electric Competition Coalition; Goldwater
 3 Institute; Land and Water Fund; Utility Group; Carl Dabelstein; RUCO; AEPCO; Navopache; Arizonans
 4 for Electric Choice and Competition; Arizona Consumers Council; APS; School Board; Attorney
 5 General; Staff; and AUIA. At the conclusion of the hearing, the matter was taken under advisement
 6 pending submission of Opening Briefs on March 16, 1998 and Reply Briefs on March 23, 1998 and the
 7 issuance of a Recommended Opinion and Order to the Commission.
 8

DISCUSSION**Introduction**

Pursuant to Decision No. 59943, the Commission approved a phase-in transition to a competitive generation electric power market commencing on January 1, 1999. In the long-run, it is believed that competition will result in lower prices, better service, more choices and increased innovation. However, the transition from regulated monopoly to a competitive market has raised some contentious issues. One of the primary issues is who should pay for the costs associated with the transition from a cost-based regulated environment to a market environment. The Affected Utilities² have claimed a reliance on building large baseline generation plants/long-term power contracts to provide electric service for all those who desired service for a promise of regulated returns over the life of the plant. This is in conflict with market priced rates, especially during a period of excess generation capacity in the Southwest Region. According to APS, there will be excess capacity up through 2006. The difference between market based prices and the regulated cost of power has been generally referred to as "stranded costs". Rates that customers pay today include 100 percent recovery of stranded costs. These stranded costs consist of the following general categories: Generation related assets; Regulatory assets; and Social costs.

Pursuant to the Electric Competition Rules, the Group developed recommendations for the analysis and recovery of stranded costs. The Group held its initial meeting on March 4, 1997. There were several other meetings held during 1997, culminating in a Working Group Report on September 30, 1997. Because of the complexity of the stranded cost issue as well as the diversity of interests, there was little consensus reached by the Group. As a result, an evidentiary hearing was established to address the stranded costs issues.

² Pursuant to R14-2-1601(1), "Affected Utilities" means the following public service corporations providing electric service: Tucson Electric Power Company, Arizona Public Service Company, Citizens Utilities Company, Arizona Electric Power Cooperative, Trico Electric Cooperative, Duncan Valley Electric Cooperative, Graham County Electric Cooperative, Mohave Electric Cooperative, Sulphur Springs Valley Electric Cooperative, Navajo Electric Cooperative, Ajo Improvement Company, and Morenci Water and Electric Company.

1 Our December 1, 1997 Procedural Order, as amended by our December 11, 1997 Procedural
2 Order, set forth nine issues to be resolved at this time:

- 3 1. Should the Electric Competition Rules be modified regarding stranded costs, if so, how?
4 2. When should "Affected Utilities" be required to make a "stranded cost" filing pursuant
5 to A.A.C. R14-2-1607?
6 3. What costs should be included as part of "stranded costs" and how should those costs be
7 calculated?

8 Sub-Issue No. 3(A): What calculation methodology is recommended, and what
9 assumptions are made including any determination of market
10 price?

11 Sub-Issue No. 3(B): Are there any implications of the Statement of Financial
12 Accounting Standards No. 71 resulting from the recommended
13 stranded cost calculation and recovery methodology?

- 14 4. Should there be a limitation on the time frame over which "stranded costs" are calculated?
15 5. Should there be a limitation on the recovery time frame for "stranded costs"?
16 6. How and who should pay for "stranded costs" and who, if anyone, should be excluded
17 from paying for stranded costs?
18 7. Should there be a true-up mechanism and, if so, how would it operate?
19 8. Should there be price caps or a rate freeze imposed as part of the development of a
20 stranded cost recovery program and if so, how should it be calculated?
21 9. What factors should be considered for "mitigation" of stranded costs?

22 All of these questions are generally inter-related to the primary issue of how much, if any, of
23 stranded costs should be collected by the Affected Utilities. That issue can be divided into what
24 methodology should be used in calculating stranded costs and how much of those costs should be
25 recovered by the Affected Utilities. Further, we believe Question Nos. 3, 4, 5 and 9 go directly to those
26 issues. As a result, we will initially focus on the following Questions:

27 Question No. 3: What costs should be included as part of "stranded costs" and how should
28 those costs be calculated?

Question No. 4. Should there be a limitation on the time frame over which "stranded costs"
are calculated?

Question No. 5. Should there be a limitation on the recovery time frame for "stranded
costs"?

1 Question No. 9. What factors should be considered for "mitigation" of stranded costs?

2 There were a variety of recommendations both as to the method of calculating stranded costs as
3 well as the percentage of stranded costs to be recovered by the Affected Utilities. Generally the
4 methodologies fell into two broad categories: Administrative and Market.

5 The Administrative Category was represented by the Net Lost Revenues approach and the
6 Replacement Cost Valuation approach. The Net Lost Revenues approach compares the future annual
7 generation revenue requirement for the Affected Utility in a competitive market place to the annual
8 requirement under the traditional regulated market. One of the main advantages cited is that it can be
9 periodically trued-up to reflect changes.³ A disadvantage cited was the difficulty of estimating future
10 market prices. The Replacement Cost Valuation approach compares existing generation assets of the
11 Affected Utilities with the most cost-effective technology available today. An advantage is that it
12 estimates the stranded costs over the life of the assets. A disadvantage is that there is no opportunity for
13 a true-up to correct any erroneous assumptions.

14 The Market Category was represented by the Auction and Divestiture approach and the Stock
15 Market approach. The Auction and Divestiture approach would require the Affected Utilities to auction
16 off their generation assets and compare the value received to the net book value of the assets to determine
17 stranded costs. An advantage is that no estimation is required. A disadvantage is the various restrictions
18 that have to be overcome to sell the generation assets. The Stock Market approach requires a new stock
19 class to be formed which would give holders a claim against any stranded costs to be recovered. An
20 advantage is that it does not require any true-up. A disadvantage is that there is no assurance that the
21 stock valuation will have any relationship to stranded costs.

22 While the parties disagreed on the methodology to compute stranded costs, there was even more
23 disagreement as to how much, if any, of the stranded costs should be collected by the Affected Utilities.
24 The computation methodologies were generally tied to a mitigation recommendation. For example, most
25 of the parties advocating the Auction and Divestiture Approach also recommended that Affected Utilities
26 not be allowed stranded cost recovery unless they followed the Auction and Divestiture Approach.

27
28 ³ There were a variety of advantages and disadvantages given for all the categories. For discussion purposes, only one advantage and disadvantage is listed for each of the categories.

1 Some parties recommended the Affected Utilities do all possible mitigation first and then the amount of
2 stranded costs will be determined. There were a variety of proposals that would result in a sharing of
3 stranded costs between customers and shareholders, the rationale being that the best mitigation incentive
4 is for the Affected Utilities to be at risk for a portion of the stranded costs. The Affected Utilities
5 indicated that they have already put forth major mitigation efforts as evidenced by rate reductions over
6 the last several years.

7 Analysis

8 In analyzing the various proposals and the evidence in support of those proposals, we conclude
9 there are several primary objectives which must be taken into consideration in deciding the overall
10 stranded cost issue. Those primary objectives are as follows:

- 11 A. Provide the Affected Utilities a reasonable opportunity to collect 100 percent of their
12 unmitigated stranded costs;
- 13 B. Provide incentives for the Affected Utilities to maximize their mitigation effort;
- 14 C. Accelerate the collection of stranded costs into as short of a transition period as possible
15 consistent with other objectives;
- 16 D. Minimize the stranded cost impact on customers remaining on the standard offer;
- 17 E. Don't confuse customers as to the bottom line; and
- 18 F. Have full generation competition as soon as possible.

19 Our first listed objective is to provide the Affected Utilities a reasonable opportunity to collect
20 100 percent of unmitigated stranded costs. We note that this is consistent with the results in the majority
21 of other states that have decided this issue. Based on past commitments/investments, the Affected
22 Utilities have sunk costs which would be stranded if they exceed market prices. This is not surprising
23 since technology has continued to improve over time resulting in more efficient generation units.
24 Additionally, there are social costs imposed on regulated entities as well as reserve requirements, all of
25 which add to the regulated costs. The Commission has in previous rate cases determined those portions
26 of generation assets which were prudently incurred. In hindsight, some of the managerial decisions may
27 not have been prudent based on subsequent changes in technology. However, we do not find it
28 appropriate to reconsider previous management decisions which the Commission determined were
prudent at the time they were made. While we find the Affected Utilities should have a reasonable

1 opportunity to collect 100 percent of unmitigated stranded costs, we want to emphasize that there is no
2 guarantee just as there is no guaranteed recovery under traditional regulation.

3 It is our second objective to have an incentive that will result in a maximum mitigation effort by
4 the Affected Utilities. Based on the testimony, we believe there should be some type of sharing of
5 stranded costs between ratepayers and shareholders. Further, any sharing percentage would be
6 determined prior to mitigation. Some of the parties had recommended the utilities be required to make
7 every feasible mitigation effort possible and then share the remaining stranded costs. Clearly, that would
8 not provide the Affected Utilities with an opportunity to collect 100 percent of stranded costs but only
9 a pre-established percentage. We believe it is more equitable to establish a method of sharing and then
10 as an incentive the Affected Utilities keep the subsequent mitigation savings.

11 Our third objective is to minimize the duration of the transition period consistent with other
12 objectives. Generally, most of the parties recommended a transition period somewhere between three
13 to six years. It was also generally recognized that the time period will have to have some flexibility in
14 order to take into account our other listed objectives. A longer transition period will result in a reduced
15 annualized stranded cost amount.

16 The next listed objective is to minimize the stranded cost impact on the customers that remain on
17 the standard offer. One of the main concerns expressed over and over by various consumer groups was
18 that the small consumers would end up with higher costs during the transition phase and all the benefits
19 would flow to the larger users. At the time of the hearing, there had been minimal participation in
20 California by residential customers in the competitive electric market place. It is not the Commission's
21 intent to have small consumers pay higher short-term costs in order to provide lower costs for the larger
22 consumers. Accordingly, we will place limitations on stranded cost recovery that will minimize the
23 impact on the standard offer.

24 We have included the objective regarding confusion because of the results in other states. There
25 appears to have been some confusion whereby customers were told their rates were going down when,
26 in fact, if stranded costs were taken into consideration, the customers total bill actually increased. It is
27 the Commission's intent that customers of the Affected Utilities be given the bottom line results of
28 stranded costs. It should not be called a decrease unless it is a decrease on the overall bill. It also must

1 be understood that a short transition period and rate reductions are in direct contradiction.

2 Lastly, it is the Commission's intent that individual stranded cost proceedings occur as quickly
3 as possible in order to provide an opportunity for full generation competition as soon as possible. Most
4 of the participants recommended the Affected Utilities file their individual stranded cost requests as soon
5 as possible. The proposed time periods ranged from filing before the end of the hearing (City of Tucson)
6 to within 120 days of the date of this Decision (TEP). Because of the January 1, 1999 deadline for
7 commencement of the initial phase for competition, it is imperative that the earliest possible date for
8 filing of individual stranded costs be set. The Affected Utilities have indicated stranded cost filings
9 cannot be made without the additional guidance from this Decision. As a result, we find a reasonable
10 deadline for stranded cost filings by each Affected Utility to be no later than 30 days from the date of this
11 Decision.

12 The conflict between the aforementioned objectives is the reason the stranded cost issue was
13 contentious. At first blush, California appears to have satisfied all these objectives simultaneously.
14 However, what has been declared as a rate reduction disappears when the securitization portion of the
15 California plan is taken into consideration. Securitization does have the effect of reducing the annual
16 transition charge by spreading it over a much longer period of time.

17 As previously noted, we find the Affected Utilities should have a reasonable opportunity to collect
18 100 percent of their stranded costs. In order to collect 100 percent, the Affected Utilities will have to
19 mitigate stranded costs. One of the primary methods to mitigate such costs will be through customer
20 growth. We expect the Affected Utilities to have to work hard to obtain 100 percent. This will require
21 the Affected Utilities to make all reasonable efforts to mitigate stranded costs. We recognize there are
22 certain stranded costs which are more difficult to mitigate for which the Affected Utilities should have
23 more of a guarantee than other stranded costs. We find that social costs such as low-income programs,
24 DSM and renewable programs that have been approved by the Commission should be 100 percent
25 recovered. Pursuant to A.A.C. R14-2-1608 those costs are to be collected annually as system benefit
26 charges and as such are not considered stranded costs. Because of the difficulty of mitigating regulatory
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1 assets as well as the possible financial implications⁴, we believe they also should be given more of an
2 assured recovery. These are costs which would have been charged as expenses in a previous period
3 absent an implicit promise by the Commission that they be deferred as an asset and collected from
4 ratepayers in the future. However, there should not be an indefinite guarantee of a return of and on the
5 regulatory assets.

6 Based on the variety of financial conditions, types and amounts of stranded costs as well as
7 shareholder/customer relationships, we find that no one methodology will fit all Affected Utilities. As
8 a result, we will allow each Affected Utility to choose from three options: Option No. 1 - Net Revenues
9 Lost Methodology; Option No. 2 - Divestiture/Auction Methodology; or Option No. 3 - Financial
10 Integrity Methodology. Those options are described below:

11 Option No. 1 - Net Revenues Lost Methodology

12 Utilize a Net Revenues Lost Methodology similar to that set forth by APS
13 witness Davis. In general, the APS proposal compares generation
14 revenues with competition versus revenues without competition. The
15 difference, if any, is considered as potential stranded costs. That amount
16 is then allocated among rate classes utilizing traditional cost allocation and
17 rate design principles. Those customers taking service on the standard
18 offer tariff would already be paying their portion of stranded costs.
19 Customers taking competition generation service would be charged for
20 their portion of stranded costs through a competitive transition charge
21 ("CTC") charge. Under the APS proposal, the potential stranded costs
22 would be spread over all customers including customers added during the
23 year. If there is enough growth relative to customers taking competitive
24 service, all customers could end up with a decrease in rates. However,
25 there would be little incentive for customers to utilize another competitive
26 service as they would have to purchase generation at below market price
27 in order to reap any savings. We believe such a result is a major flaw in
28 the APS proposal. As a result we will modify the APS proposal to place
the risk/reward of mitigation more directly on the Affected Utilities.

We will clearly separate stranded costs into generation related
assets and regulatory assets. Any growth in customers will not be part of
the customer base in calculating the generation related asset stranded
costs. Any such growth would be considered as mitigation which the
Affected Utilities can retain. In turn, the percentage of stranded costs that
the Affected Utilities would be permitted to collect via the CTC charge
will be reduced each year. We will utilize the customer base of the
Affected Utility as of December 31, 1998 to calculate stranded costs for
each year. Any Affected Utility choosing this method will be permitted
to collect 100 percent of its stranded costs in Year No. 1 (calendar year
1999) either through the standard offer or in a CTC charge to any

⁴ A decision that results in significant write-offs of regulatory assets could seriously impair
the financial integrity of an Affected Utility.

1 customer who elects to purchase from competitors; in Year No. 2, the
 2 Affected Utility will be permitted to calculate its stranded costs over the
 3 same December 31, 1998 customer base however, only 80 percent of the
 4 proportionate amount can be recovered in a CTC charge to any customer
 5 who elects to purchase from competition. Those remaining on the
 6 standard offer will still be paying 100 percent of their proportionate share
 of stranded costs. Any short fall the Affected Utility may have from the
 December 1998 customer base could be more than made up from post
 1998 customer growth. In Year Nos. 3, 4, and 5, the Affected Utility will
 utilize the same methodology only the percentages to be collected via the
 CTC charge will be 60, 40, and 20 percent, respectively.

7 Because regulatory assets are more difficult for an Affected
 8 Utilities to mitigate and as such need to have different treatment, we will
 9 permit an Affected Utility to collect 100 percent of the appropriate
 10 regulatory assets over its existing amortization period. Further, all
 11 existing and future customers should bear their portion of the regulatory
 12 assets either as part of the standard offer or as part of the CTC charge. In
 13 order to encourage Affected Utilities to make maximum effort to mitigate
 14 regulatory assets, we will phase out any return on such assets after a five
 15 year period. For regulatory assets which are receiving a rate of return,
 such rate of return should be reduced by 20 percent per year so that after
 five years⁵ there would be no return allowed on such assets. As the rate
 of return is reduced, all rates including those customers on standard offer
 rates should be reduced accordingly. Upon expiration of the amortization
 period for regulatory assets, standard offer rates should be reduced to
 reflect the removal of the regulatory assets. If an Affected Utility believes
 other costs have increased to offset the removal of the regulatory assets,
 it shall file a rate case at least a year before regulatory assets are
 extinguished.

16 Option No. 2 - Divestiture/Auction Methodology

17 The second option is to determine the amount of stranded costs by
 18 divesting/auctioning off all non-essential generation assets. Each
 19 generation asset will have to include its portion of the appropriate
 20 regulatory assets. The difference between the net market value and book
 21 value will be stranded costs. We will permit the Affected Utility to collect
 22 100 percent of the stranded costs on an equal basis over a ten year period.⁶
 All customers connected to the Affected Utilities grid shall pay their
 appropriate share either through a CTC charge or through the standard
 offer rate. We will not allow any carrying charges on the unamortized
 balance. If the resulting customer charge would result in an increase in
 the standard offer rate, the Affected Utility will have to defer those excess
 amounts for future periods without any carrying charges.

24 Option No. 3 - Financial Integrity Methodology

25 The third option would be to maintain financial viability of the Affected

26 ⁵ Including the initial five year period, any rate of return will be phased out after a total of
 27 ten years.

28 ⁶ If the stranded cost amount is determined to be negative, ratepayers and shareholders
 should receive an equal share of such amount.

1 Utility for a period of ten years. This would require sufficient revenues
 2 to meet minimum financial ratios. At the end of ten years, there would be
 3 no remaining stranded costs. All customers would have to pay their share
 4 either through the standard offer or CTC charges.

5 Individual Stranded Cost Filings

6 Within thirty days of the date of this Decision, each of the Affected Utilities shall file its choice
 7 of options for stranded cost recovery. In addition, the Affected Utility will need to file an implementation
 8 plan that would include the following items if appropriate for their option choice: the estimation of
 9 stranded costs separated out into regulatory assets and other generational related assets; the market price
 10 index to be utilized⁷; the plan for auction/divestiture of assets; the minimum financial ratios to maintain
 11 financial viability for ten years; the amount of regulatory assets requested, how much of those assets are
 12 generation related, and the Commission Decision No. that approved such assets; and other information
 13 as necessary.

14 Question No. 1: Should the Electric Competition Rules be modified regarding stranded
 15 costs, if so, how?

16 The majority of the parties did not believe the Rules need any significant modifications.
 17 However, most parties recommended some minor modification/clarifications.

18 A.A.C. R14-2-1601(8) ("Rule 1601(8)") contains the following stranded cost definition:

19 R14-2-1601(8):

20 8. "Stranded Cost" means the verifiable net difference between:

- 21 a. The value of all the prudent jurisdictional assets and obligations necessary
 22 to furnish electricity (such as generating plants, purchased power
 23 contracts, fuel contracts, and regulatory assets), acquired or entered into
 24 prior to the adoption of this Article, under traditional regulation of
 25 Affected Utilities; and
- 26 b. The market value of those assets and obligations directly attributable to
 27 the introduction of competition under this Article.

28 In general, the Affected Utilities were of the opinion that some post-1996 costs should be fairly
 included as stranded costs. For that reason, most of the Affected Utilities requested the phrase "acquired

⁷ We believe either the Palo Verde Dow Jones Index or the California Power Exchange
 Index are appropriate as a starting point. However, any market price should include a blend of spot, short
 term, and long term power.

1 or entered into prior to the adoption of the Article" should be deleted. Other parties filed opposition to
2 such a change.

3 We believe there does need to be a reasonable cutoff period for stranded costs and the approval
4 date of the Electric Competition Rules is a reasonable cutoff. While the Affected Utilities may have
5 additional costs related to transactions in implementing electric competition, those costs, if reasonable,
6 can be factored into the market price. For clarification, the following should be added after "adoption
7 of this Article"; "or after the adoption of this Article if approved by the Commission".

8 A.A.C. R14-2-1607 ("Rule 1607") provides guidance for the recovery of stranded costs. Rule
9 1607(A) reads as follows:

10 R14-2-1607(A):

- 11 A. The Affected Utilities shall take every feasible, cost-effective measure to mitigate
12 or offset Stranded Cost by means such as expanding wholesale or retail markets,
13 or offering a wider scope of services for profit, among others.

14 In general, all the Affected Utilities opposed the requirement to take "every feasible, cost-
15 effective measure to mitigate . . . such as expanding wholesale or retail markets. . . ." According to the
16 Affected Utilities, a more appropriate requirement would be to "make reasonable efforts to mitigate
17 avoidable stranded costs". Further, the Affected Utilities opined that any mitigation should not include
18 revenues from unrelated activities to offset stranded costs.

19 While it was the Commission's intent for the Affected Utilities to aggressively pursue mitigation
20 efforts, we recognize it is virtually impossible to identify every "feasible cost effective measure". As a
21 result, we agree that Rule 1607 needs to be clarified by replacing "feasible" with "reasonable". As to the
22 request to not include revenues from unrelated activities, we believe no clarification is necessary since
23 the Commission is limited in its jurisdiction.

24 Rule 1607(B) reads as follows:

25 R14-2-1607(B): The Commission shall allow recovery of unmitigated Stranded Cost by
26 Affected Utilities.

27 Several of the non-Affected Utilities requested that Rule 1607(B) be clarified to provide that
28 Affected Utilities will be afforded an opportunity (not a guarantee) to recover legitimate unmitigated

1 stranded costs. There was also a request that Rule 1607(B) be clarified to provide that any stranded cost
2 recovery would commence with the introduction of retail competition.

3 In reading the Rules as a whole, we believe it is already clear that stranded cost recovery will
4 commence with the introduction of retail competition. We also believe that a reading of the Rules in their
5 entirety places the burden on the Affected Utility to demonstrate they have aggressively pursued
6 mitigation efforts. As a result, the Affected Utility has a high burden of proof regarding its mitigation
7 efforts. If such burden is not met, then the Affected Utility should not be allowed carte blanche recovery.
8 Even the Affected Utilities acknowledged during the hearing that they did not want a guarantee but only
9 a reasonable opportunity for recovery of legitimate unmitigated stranded costs. Accordingly, we will
10 modify Rule 1607(B) by inserting the words "a reasonable opportunity for" after the word "allow".

11 R14-2-1607(G):

12 G. The Affected Utilities shall file estimates of unmitigated Stranded Cost. Such
13 estimates shall be fully supported by analyses and by records of market
14 transactions undertaken by willing buyers and willing sellers.

15 PG&E requested Rule 1607(G) be modified to provide an explicit date for Affected Utilities to
16 file estimates of unmitigatable stranded costs. Electric Choice proposed Rule 1607(G) be modified to
17 provide that stranded cost estimates be filed at least eight months prior to the date of commencement of
18 recovery.

19 As previously discussed, each Affected Utility is being ordered to file its choice of options for
20 stranded cost recovery along with a detailed plan which will include stranded cost estimates.
21 Accordingly, we do find it necessary to change Rule 1607(G).

22 R-14-2-1607(I):

23 A.A.C. R14-2-1607(I) ("Rule 1607(I)") lists various factors to consider in determining the
24 magnitude of stranded costs. AEPCO proposed a prudence exclusion be added to Rule 1607(I).
25 According to AEPCO, such an exclusion will avoid time consuming debate over issues which have
26 previously been settled. AEPCO's proposed language is as follows: "The prudence of an Affected
27 Utilities' investment prior to the effective date of this article which the Commission had a reasonable
28 opportunity to evaluate shall not be at issue in the stranded cost determination."

It is not the Commission's intent to go back and revise previous prudency determinations. This

1 does not mean that the Commission may not consider changed circumstances and resulting management
2 decisions subsequent to previous prudency determinations. The Commission does not find it necessary
3 to list a new factor as part of Rule 1607(I) at this time.

4 A.A.C. R14-2-1607(J) ("Rule 1607(J)") provides guidance as to who stranded costs may be
5 recovered from:

6 R14-2-1607(J):

7 J. Stranded Cost may only be recovered from customer purchases made in the
8 competitive market using the provisions of this Article. Any reduction in
9 electricity purchases from an Affected Utility resulting from self-generation,
10 demand side management, or other demand reduction attributable to any cause
11 other than the retail access provisions of this Article shall not be used to calculate
12 or recover any Stranded Cost from a consumer.

11 PG&E requested Rule 1607(J) be clarified to indicate that stranded costs are recoverable from all
12 retail generation customers who remain connected to the transmission and distribution systems regardless
13 of the source of power. APS requested a similar clarification and proposed deletion of the first sentence
14 starting with "Stranded Cost may". AEPCO proposed all language after "customer" be deleted.

15 It was the Commission's intent in Rule 1607(J) to make sure customers on the standard offer were
16 not charged stranded costs as part of a transition charge in addition to an identical allocation as part of
17 the standard offer. As a result, all customers connected to the transmission and distribution systems will
18 be paying a share of stranded costs in some form but there will be no double charge allowed. We do not
19 find that any change is necessary to Rule 1607(J).

20 A.A.C. R14-2-1608 ("Rule 1608") provides guidance on what can be collected as a system benefit
21 charge.

22 R14-2-1608:

23 A. By the date indicated in R14-2-1602, each Affected Utility shall file for
24 Commission review non-bypassable rates or related mechanisms to recover the
25 applicable pro-rata costs of System Benefits from all consumers located in the
26 Affected Utility's service area who participate in the competitive market. In
27 addition, the Affected Utility may file for a change in the System Benefits charge
28 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, renewables, and nuclear
power plant decommissioning programs.

According to APS, nuclear fuel disposal costs are an inherent part of nuclear decommissioning

1 costs which are recoverable through the System Benefits charge. As a result, APS requested Rule
2 1608(A) be clarified to specifically include the recovery of nuclear disposal costs. ACAA and RUCO
3 proposed that nuclear fuel disposal and decommissioning charges are directly related to generation and
4 as a result should be part of stranded costs not system benefits.

5 We concur with APS that nuclear fuel disposal costs are an inherent part of nuclear
6 decommissioning costs. Further, for public health and public safety reasons we do not believe these
7 should be lumped in with stranded costs. We believe Rule 1608(A) is clear without the change proposed
8 by APS.

9 Question No. 3: What are the Implications of FAS 71?

10 The Affected Utilities must prepare their public financial statements in accordance with Statement
11 of Financial Accounting Standard No. 71, Accounting for the Effects of Certain Types of Regulation
12 ("FAS 71"). Pursuant to FAS 71, the Commission can create an asset by deferring, for future recovery,
13 a current cost that would otherwise be charged to expense. These are referred to as regulatory assets and
14 may continue to be reflected on a utility's books and financial statements as long as the following criteria
15 are met: 1) It is probable that future revenue in an amount at least equal to the capitalized cost will result
16 from inclusion of that cost in rates; and 2) Based on available evidence, future revenue will be provided
17 to permit recovery of the previously incurred cost rather than to provide for expected levels of similar
18 future costs.

19 According to the Affected Utilities, the financial community is looking for assurances from the
20 Commission that the Affected Utilities will be provided a return on and return of their investments.
21 Without such assurances, the Affected Utilities will have to write-down and/or write-off some of the
22 investments.

23 Most of the parties acknowledged that regulatory assets need to be treated differently than
24 generation assets. However, some of the non-Affected Utilities opined that accounting rules should not
25 drive regulatory policy. We believe the stranded cost recovery mechanisms approved herein will provide
26 the Affected Utilities sufficient revenues to enable them to recover the appropriate regulatory assets.
27 Accordingly, there should be no necessity for write-downs and/or write-offs.
28

1 Question No. 7: Should there be a True-up Mechanism and, if so, How Would it Operate?

2 Most of the parties tied the need of any true-up to the stranded costs methodology they
3 recommended. There were concerns expressed that a true-up mechanism could result in
4 uncertainty/confusion for customers and thus inhibit competition. In general, the non-Affected Utilities
5 believed a downward true-up mechanism was a good idea.

6 Of the three options approved herein, we believe only Option No. 1 requires any type of true-up.
7 On an annual basis, the Affected Utility should file a reconciliation for approval by the Commission of
8 its estimated market price with actual market price with adjustments on a going forward basis.

9 Question No. 8: Should there be a Price Cap or Rate Freeze?

10 Generally, the Affected Utilities opposed any price cap or freeze. On the other hand, many of the
11 other parties supported a price cap but not a rate freeze. Those parties representing various small
12 consumers were especially vociferous about having some type of price cap. There was a concern that
13 larger users would reap all the benefits of competition while the smaller users would bear the brunt of
14 higher costs.

15 We share the concerns expressed by small consumer groups. If small consumers are not going
16 to have benefits in the short run, they should not be unfairly burdened with increased rates resulting from
17 the transition costs. While we agree that small consumers deserve some rate protection during the
18 transition period, we are also concerned that the transition costs may require some increase. We have
19 placed a limitation that customers on the standard offer will not receive an increase as a result of stranded
20 costs. Any stranded costs which would result in an increase to the standard offer will have to be deferred
21 to a future period. However, an Affected Utility can still file a rate case and request an increase for
22 reasons other than stranded costs during the transition period.

23 Miscellaneous

24 A. School Board Variance/Exemption:

25 The School Board requested a variance/exemption for its share of any stranded costs. According
26 to the School Board, its request should be granted because of the school funding crisis in Arizona and
27 because it is in the public interest. Further, the School Board asserted that its proposal would not result
28 in any cost-shifting between or within customer classifications as the economic burden would be borne

1 by the Affected Utility or its shareholders.

2 Other parties opposed the School Board's request because it would result in preferential treatment
3 which would be unlawful and if granted, the request would open the floodgates for every worthwhile
4 enterprise to claim a similar exemption.

5 We do not agree with the School Board's assertion that their proposal would not result in cost
6 shifting. Clearly, either other ratepayers and/or other shareholders would pick up the additional costs.
7 Any solution to the School Board funding problems must be dealt with by the legislature on a state-wide
8 basis. Accordingly, the requested variance/exemption is denied.

9 B. Allocation Methodology:

10 There were some discussions regarding the allocation methodology for stranded costs. It is the
11 Commission's intent that all present and future customers should pay their fair share of stranded costs.
12 As a result, we will adopt a rebuttable presumption that all customers connected to the grid should pay
13 an appropriate amount of stranded costs consistent with the current approved rate treatment of each
14 Affected Utility.

15 C. Exit Fees:

16 Several of the parties expressed an interest in an exit fee that would enable them to make an up-
17 front buy out of their portion of stranded costs. We will order each Affected Utility to develop a
18 discounted stranded costs exit methodology that a customer may choose to determine an amount in lieu
19 of making monthly payments. The methodology should be developed with input from interested parties
20 and approved by the Commission.

21 SUMMARY

22 Pursuant to Decision No. 59943, the Commission committed to electric generation competition
23 commencing on January 1, 1999. There are still details which must be resolved prior to such
24 competition. The most contentious issue still needing to be resolved is that of stranded costs. In general,
25 the Affected Utilities have indicated they have the right to such costs because they have followed the
26 "rules of the game." Most of the larger consumers are saying the rules of the game have changed and
27 the remaining baggage from the previous game is the problem of the Affected Utility. The smaller
28 consumers aren't as concerned with the rule changes but do not want to be declared the losers before the

1 game begins.

2 The Commission has attempted in this Decision to carefully balance the various concerns. As
3 a result, we believe the Affected Utilities will have a reasonable opportunity to collect 100 percent of
4 their stranded costs over a relatively short transition period, customers who desire to utilize a competitive
5 generation source will have an opportunity to obtain a more favorable rate than can be obtained through
6 the standard offer, and those customers who remain on the standard offer will not receive a rate increase
7 as a result of stranded costs. We want to make it clear that this overall scenario is only possible through
8 continued growth in Arizona as well as increased efficiencies by the Affected Utility. Growth will help
9 Affected Utilities mitigate potential losses of customers to competition. At the same time, the Affected
10 Utilities will need to continue to tighten their belts in order to bring their costs down to the market by the
11 end of the transition period. After the Affected Utilities have collected the expenses associated with their
12 appropriate regulatory assets, all customers remaining on the standard offer should receive a reduction
13 in their overall rates.

14 * * * * *

15 Having considered the entire record herein and being fully advised in the premises, the
16 Commission finds, concludes, and orders that:

17 **FINDINGS OF FACT**

- 18 1. The Commission issued Decision No. 59943 which approved the Electric Competition
- 19 Rules.
- 20 2. Decision No. 59943 approved a phase-in transition to a competitive generation power
- 21 market commencing on January 1, 1999.
- 22 3. In the long-run it is believed that competition will result in lower prices, better service,
- 23 more choices, and increased innovation.
- 24 4. The Commission issued Decision No. 60351 which directed the Hearing Division "to
- 25 produce procedural orders in order to establish hearings, evidentiary or otherwise, regarding any aspect
- 26 of electric competition that is necessary and appropriate".
- 27 5. On September 30, 1997, the Group filed its Report to the Commission.
- 28 6. On October 30, 1997, RUCO filed a Request for Hearing.

1 7. Our December 1, 1997 Procedural Order set an evidentiary hearing on generic issues
2 related to stranded costs commencing on February 9, 1998.

3 8. The difference between market based prices and the cost of regulated power has been
4 generally referred to as stranded costs.

5 9. According to APS, there will be excess generation capacity in the Southwest Region up
6 through 2006.

7 10. Stranded costs consist of the following general categories: Generation related assets;
8 Regulatory Assets; and Social costs.

9 11. The September 30, 1997 Working Group Report contained little consensus on stranded
10 cost issues.

11 12. Our December 1, 1997 Procedural Order, as amended by our December 11, 1997
12 Procedural Order, set forth nine issues to be resolved:

13 Question No. 1. Should the Electric Competition Rules be modified regarding stranded
14 costs, if so, how?

15 Question No. 2. When should "Affected Utilities" be required to make a "stranded cost"
16 filing pursuant to A.A.C. R14-2-1607?

17 Question No. 3. What costs should be included as part of "stranded costs" and how should
18 those costs be calculated?

19 Question No. 3A. What calculation methodology is recommended, and what assumptions
20 are made including any determination of market price?

21 Question No. 3B. Are there any implications of the Statement of Financial Accounting
22 Standards No. 71 resulting from the recommended stranded cost
23 calculation and recovery methodology?

24 Question No. 4. Should there be a limitation on the time frame over which "stranded costs"
25 are calculated?

26 Question No. 5. Should there be a limitation on the recovery time frame for "stranded
27 costs"?

28 Question No. 6. How and who should pay for "stranded costs" and who, if anyone, should
be excluded from paying for stranded costs?

 Question No. 7. Should there be a true-up mechanism and, if so, how would it operate?

 Question No. 8. Should there be price caps or a rate freeze imposed as part of the
development of a stranded cost recovery program and if so, how should
it be calculated?

1 Question No. 9. What factors should be considered for "mitigation" of stranded costs?

2 13. The methods of calculating stranded costs falls into two broad categories: Administrative
3 and Market.

4 14. The Administrative Category was represented by the Net Lost Revenues approach and the
5 Replacement Cost Valuation approach.

6 15. The Market Category was represented by the Auction and Divestiture approach and the
7 Stock Market approach.

8 16. Each of the categories and respective approaches have some advantages and
9 disadvantages.

10 17. Rate reductions over the last several years reflect mitigation efforts put forth by the
11 Affected Utilities in contemplation of competition.

12 18. Affected Utilities should have a reasonable opportunity to collect 100 percent of their
13 unmitigated stranded costs.

14 19. Traditional regulation does not guarantee 100 percent recovery of costs but only a
15 reasonable opportunity to recover costs.

16 20. A longer transition period will result in a reduced annualized stranded cost amount.

17 21. Securitization is a financing method that can be utilized to spread stranded costs over a
18 longer period and thus minimize the annual impact.

19 22. A short transition period and rate reductions are in direct contradiction.

20 23. Regulatory assets are costs which would have been charged as expenses in a previous
21 period absent an implicit promise by the Commission that they be deferred as an asset and collected from
22 ratepayers in the future.

23 24. No one methodology for calculating stranded costs will fit all Affected Utilities.

24 25. Any stranded cost recovery methodology must balance the interests of the Affected
25 Utilities, ratepayers, and a move toward competition.

26 26. The Net Revenues Lost Methodology proposed by APS provides little incentive for
27 customers to utilize another competitive service.

28 27. Affected Utilities should be given more of an assured recovery for regulatory assets and

1 social costs than for other generation related stranded costs.

2 28. All current and future customers of the Affected Utilities should pay their fair share of
3 regulatory assets and social costs.

4 29. Arizona's population has been steadily growing.

5 30. Customer growth will help Affected Utilities mitigate stranded costs.

6 31. The stranded cost options approved herein should provide sufficient cash flow for the
7 Affected Utilities to recover their appropriate regulatory assets.

8 32. Stranded cost recovery is not an opportunity to revisit prudence of previous generation
9 asset decisions.

10 33. In general, a five year transition period is reasonable with flexibility for additional time
11 to take into account other objectives.

12 34. A reasonable deadline for stranded cost filing by each Affected Utility is no later than 30
13 days from the date of this Decision.

14 **CONCLUSIONS OF LAW**

15 1. The Affected Utilities are public service corporations with the meaning of the Arizona
16 Constitution, Article XV, under A.R.S. §§ 40-202, -203, -250, -321, -322, -331, -332, -336, -361, -365,
17 -367, and under the Arizona Revised Statutes, Title 40, generally.

18 2. The Commission has jurisdiction over the Affected Utilities and of the subject matter
19 contained herein.

20 3. Notice of the proceeding has been given in the manner prescribed by law.

21 4. The Electric Competition Rules should be amended consistent with this Decision.

22 **ORDER**

23 IT IS THEREFORE ORDERED that within 30 days of the date of this Decision, each Affected
24 Utility as defined in A.A.C. R14-2-1601(1) shall file its choice of options for stranded cost recovery.

25 IT IS FURTHER ORDERED that each Affected Utility shall file an implementation plan with
26 its stranded cost option which should set forth the details for its plan including its estimated stranded
27 costs separated out into regulatory assets and other generation related assets.

28 IT IS FURTHER ORDERED that within 30 days of each Affected Utility filing its

1 implementation plan, all other parties shall file any comments/disagreements and requests for hearing.

2 IT IS FURTHER ORDERED that there is a rebuttable presumption that stranded costs shall be
3 allocated in a manner consistent with the current rate treatment for each Affected Utility.

4 IT IS FURTHER ORDERED that the Director of the Utilities Division shall submit rule
5 amendments as set forth herein to the Secretary of State's office commencing the process of rule adoption
6 on an emergency basis.

7 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

8 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

9
10
11 _____
12 COMMISSIONER - CHAIRMAN COMMISSIONER COMMISSIONER

13 IN WITNESS WHEREOF, I, JACK ROSE, Executive Secretary of the Arizona
14 Corporation Commission, have hereunto set my hand and caused the official seal
15 of the Commission to be affixed at the Capitol, in the City of Phoenix, this
16 _____ day of _____, 1998.

17 _____
18 JACK ROSE
19 EXECUTIVE SECRETARY

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