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EXCEPTION

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Arizona Corporation Commission

BEFORE THE ARIZONA CORPORATION COMMISSION

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

DOCKET NO. RE-00000C-94-0165
EXCEPTIONS TO PROPOSED
OPINION AND ORDER

The Arizona Electric Power Cooperative, Inc. ("AEPSCO"),
Duncan Valley Electric Cooperative, Inc. ("Duncan"), Graham County
Electric Cooperative, Inc. ("Graham") and Sulphur Springs Valley
Electric Cooperative, Inc. ("Sulphur Springs") and Trico Electric
Cooperative, Inc. ("Trico") (collectively "the Cooperatives") submit
these exceptions to the Hearing Officer's Proposed Opinion which was
issued on May 6, 1998 (the "Proposed Opinion").

These exceptions focus on items of major concern to the
Cooperatives without waiver of their ability to address different or
additional matters based on this record including, but not limited
to, filings of the other parties.¹ Incorporated herein by this
reference are AEPSCO's Initial Brief and Reply Brief. For
convenience, a copy of the Initial Brief and Reply Brief are attached
to the original of these exceptions filed with Docket Control and the
copies provided to the Commissioners.

The nature of exceptions is to highlight failings and
foibles of the Proposed Opinion. This writing will be no exception

¹ The Cooperatives' participation in this and other stranded
cost proceedings is without waiver of their rights to pursue adequate
remedies for compensation in relation to loss of their vested
property rights pursuant to the State and Federal Constitutions.

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1 to that general rule. Notwithstanding that, the Cooperatives commend
2 the Hearing Officer for the conduct of a complex, multiparty
3 proceeding involving complicated issues conducted over a very
4 compressed period of time. Although the Cooperatives take exceptions
5 to various provisions of the Proposed Opinion, they appreciate and
6 acknowledge the efforts of the Hearing Officer in attempting to
7 resolve these difficult issues.

8 **Regulatory Assets.**

9 One of the primary failings of the Proposed Opinion is its
10 inadequate, non-differentiated treatment of regulatory assets.
11 Although the Proposed Opinion attempts to deal separately with
12 regulatory assets at pages 11 and 12, (1) it is unclear whether that
13 separation is limited only to the net revenues lost method and (2)
14 the limits on recovery of regulatory assets there undoubtedly would
15 require large write-offs.

16 In general, all witnesses agreed that regulatory assets
17 should be afforded different and preferential treatment for a variety
18 of reasons including, but not limited to, the facts that they are
19 sunk costs incapable of being mitigated which have little, if any,
20 market value. Also, inadequate or improper regulatory allowance for
21 recovery of regulatory assets in this and other Commission
22 proceedings will have immediate and dire FASB 71 consequences likely
23 to lead, as the Hearing Officer acknowledged, to serious impairment
24 of the financial integrity of an Affected Utility. Finally, any
25 decision affecting the utility's ability to recover regulatory assets

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1 would raise serious jurisdictional issues pursuant to A.R.S.
2 § 40-252.

3 In AEPCO's case, its regulatory assets total approximately
4 \$31 million. To place this amount in some context, that is roughly
5 11% of AEPCO's net utility plant value. The vast majority of these
6 regulatory assets are costs already incurred but deferred for future
7 recovery so as to (1) renegotiate and reduce AEPCO's fuel costs and
8 (2) refinance and reduce AEPCO's debt costs. The benefits of the
9 cost reductions these regulatory assets produced have been flowing to
10 AEPCO's member-owners and their customer-owners for many years. The
11 reduced costs associated with these regulatory assets are a primary
12 reason why over the past 12 years AEPCO has been able to reduce its
13 rates by more than 21% and in addition to return more than
14 \$16 million in cash refunds to its members.

15 Rather than the Proposed Opinion's approach of treating
16 regulatory assets together with other stranded costs, the
17 Cooperatives would suggest that regulatory assets simply be placed in
18 their own category - regardless of choices made and methods used for
19 recovery of other stranded costs. Filings concerning the size,
20 identity, recommended recovery period and other details concerning
21 regulatory assets would be made with the Commission. These
22 proceedings should be less contested and controversial than those
23 involving other stranded cost issues. Therefore, they might be dealt
24 with as Open Meeting items without the necessity of a hearing.

25 **Distribution Stranded Costs.**

26 The Proposed Opinion fails to address the issue of stranded
27 costs which may arise in the future at the distribution level.

28

1 Several witnesses agreed that distribution entities, in general, and
2 distribution cooperatives specifically may incur stranded costs in
3 the metering, meter reading, billing and collection areas, but also
4 agreed that those costs are not capable of ascertainment nor
5 quantification at this time. The uncertainty concerning distribution
6 related stranded costs is heightened further by various conflicting
7 proposals currently being circulated at the Commission as well as
8 different competition criteria in HB 2663 - both of which call into
9 question precisely when and at what level certain distribution
10 related services such as metering, meter reading, billing and
11 collection will in fact be competitive.

12 The Proposed Opinion conflicts on this subject. On the one
13 hand, it does contemplate a Rule amendment to allow stranded costs
14 arising after the adoption of the Rules, if approved by the
15 Commission. On the other hand, as currently written, any stranded
16 cost proposal would have to be submitted within 30 days of the
17 Order's effective date. This would preclude stranded cost recovery
18 requests by distribution cooperatives well in advance of a point when
19 the stranded costs could be fairly accurately quantified or even
20 anticipated.

21 To address this issue, the Cooperatives would suggest that
22 a new subsection be added to R14-2-1607 which expressly provides that
23 application may be made by an Affected Utility as to distribution
24 related stranded costs arising after competition is implemented.

25 **Calculation Methodologies.**

26 There are a number of difficulties with the calculation
27 methodologies and individual stranded costs filing discussions at
28

1 pages 11 to 13 of the Proposed Opinion. Key problems are as follows:

- 2 ● Although on its face the Proposed Opinion purports to
3 allow Affected Utilities an opportunity to recover
4 100% of stranded costs, analysis quickly reveals that
5 the methods authorized do not deliver on that promise.
6 For example, the net revenues lost assumption that, in
7 effect, there would be 100% growth in a five year
8 period is not only not supported by any record
9 evidence, but is contrary to the record evidence. It
10 certainly is a blanket assumption which has little, if
11 any, application to the rural areas of the state. The
12 effect is to reduce by at least 50% and possibly more
13 any realistic opportunity to recover unmitigated
14 stranded costs.
- 15 ● The three options proposed force utilities to select
16 one to the exclusion of others rather than allowing
17 utilities to fashion an overall plan which might
18 contain rational cost effective blends of different
19 options.
- 20 ● It is possible that the Financial Integrity
21 Methodology at pages 12-13 might be a workable
22 solution for the Cooperatives. However, no details
23 are available as to what the "minimum financial
24 ratios" would be. Therefore, entities choosing this
25 method would be purchasing the classic "pig in a
26 poke." AEPCO is also not certain what accounting
27 write-off/financial statement impacts the ten year
28 recovery limitation might have.
- The thirty day filing requirement is simply
inadequate. It will serve no one well and, in fact,
may retard progress and processing if utilities are
forced to make filings in haste. Sixty days is an
absolute minimum in which to prepare an adequate
filing.
- Finally, the options presented do not take into
account the significant differences between investor
owned utilities and customer owned cooperatives. The
latter have no shareholder/customer conflict or profit
motive. All witnesses agreed that cooperatives,
because of these and other differences, deserved
different stranded cost treatment.

At least some of these concerns could be addressed by making the
discussion of the three options permissive rather than mandatory and
changing their details from absolute maxims to guidelines. Affected

1 RESPECTFULLY SUBMITTED this 29th day of May, 1998.

2 GALLAGHER & KENNEDY, P.A.

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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE COMPETITION) DOCKET NO. RE-00000C-94-0165
IN THE PROVISION OF ELECTRIC) (formerly U-0000-94-165)
SERVICES THROUGHOUT THE)
STATE OF ARIZONA) **INITIAL BRIEF OF**
) **ARIZONA ELECTRIC POWER**
) **COOPERATIVE, INC.**

Pursuant to the Procedural Order dated March 3, 1998, Arizona Electric Power Cooperative, Inc. ("AEPCO") submits this Initial Brief in relation to the above entitled matter. As requested, this Brief will set forth a summary of AEPCO's responses to the eleven questions contained in the Procedural Orders dated December 1 and December 11, 1997.

INTRODUCTION

After more than thirty witnesses, 4,000 pages of transcripts and three weeks of hearing, one thing has been established beyond any doubt: Cooperatives are different. In describing their lack of shareholder/customer conflict, former California Public Utilities Commission Chairman Daniel Fessler phrased it lyrically:

[N]ot on you, not on me, stick it to the fellow behind the tree. [In cooperatives' case] there wasn't any fellow behind the tree...¹

As the Commission is aware, Cooperatives are nonprofit, customer owned, customer run organizations. They provide service to areas which, regardless of ones' feelings about the benefits of

¹ Hearing Transcript (hereinafter HR TR), p. 534, ll. 1-4.

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1 competition, are likely to be most at risk in the transition to a
2 competitive marketplace. Former NARUC President Kenneth Gordon
3 agreed, at a minimum, that rural areas would see delayed
4 competition benefits:

5 Q. Would it be prudent, since, obviously, we
6 don't know what's going to happen, that
7 perhaps that would emphasize the need to
8 at least make sure that the institutions,
9 organizations that have been serving in
10 this case, rural Arizona, are kept
11 financially viable, if nothing else than
12 to hedge that bet to see how the
13 competitive marketplace might play out?

14 A. Yes. I think not just for that
15 reason. It just seems to be me
16 reasonable, if they are performing
17 their utility service properly, it
18 seems reasonable to treat them
19 equitably and maintain whatever the -
20 - have customers paying whatever the
21 appropriate costs are to keep the
22 businesses on a good going forward
23 basis with or without competition.²

24 Ms. Pruitt, on behalf of the Arizona Community Action Association,
25 agreed that a different set of answers was appropriate for
26 cooperatives than investor owned utilities in relation to stranded
27 costs.³ Similarly, Dr. Coyle, on behalf of the City of Tucson,
28 agreed that stranded costs concerns he expressed generally in his
testimony were not appropriate in relation to customer owned
cooperatives.⁴

Dr. Cooper, on behalf of the Arizona Consumers Council,
stated that cooperatives are in many respects different than

² HR TR, p. 744, l. 11 to p. 744, l. 1. (emphasis supplied).

³ HR TR, pp. 266 to 267.

⁴ HR TR, p. 1095, l. 20 to p. 1096, l. 24.

1 investor owned utilities and appropriately should be treated
2 differently in relation to stranded costs. A copy of Dr. Cooper's
3 testimony in this regard is attached hereto as Exhibit A.

4 AEPCO and its member distribution cooperatives have
5 doubts about this great competition experiment and the benefits it
6 may or may not bring to rural Arizona. They serve markets that
7 even a highly regulated industry left unserved for much of this
8 century. As Mr. Minson, AEPCO's Assistant General Manager -
9 Finance, described on cross-examination, competition initiatives in
10 other industries have often left rural Arizona disadvantaged. Four
11 branch bank offices used to exist in Benson. Upon deregulation,
12 there are now two. In airlines, even a major city like Tucson is
13 disadvantaged. In order to obtain cheaper fares, one must first
14 fly to Phoenix.⁵ However, Mr. Minson had an answer for safeguards
15 to protect these rural customers in a competitive environment:

16 I think if you maintain, if you allow AEPCO and
17 its distribution cooperatives to maintain their
18 financial viability, I am speaking here
19 specifically of stranded costs, we can do the
20 job. But we have got to be given the
21 opportunity.⁶

22 AEPCO would request that the Commission keep these differences and
23 this solution in mind in reviewing its responses to the specific
24 questions concerning stranded costs.

- 25
- 26 **1. Should the Electric Competition Rules be modified regarding**
27 **stranded costs, if so, how.**
- 28

⁵ HR TR, p. 3050, l. 14 to p. 3051, l. 14.

⁶ HR TR, p. 3051, ll. 17 to 21.

1 AEPCO has suggested three amendments to the Rules
2 regarding stranded costs. They were discussed at pages 9 to 10 of
3 Mr. Minson's Direct Testimony (AEPCO Exhibit 3).

4 First, in relation to mitigation duties and allowable
5 profits and expenses, the following new language should be
6 substituted for the current R14-2-1607.A:

7 A. The affected utilities shall undertake
8 reasonable, cost effective measures to
9 mitigate or offset Stranded Cost.
10 However, neither revenues from nor
11 expenses incurred in non-jurisdictional
12 activities shall be considered in
13 mitigation or calculation of Stranded
14 Cost.

11 Almost all parties presenting testimony were in agreement that
12 nonjurisdictional activities should not be credited or debited
13 against stranded costs.

14 Second, most parties were also in agreement that stranded
15 cost recovery should be assessed against all customers.⁷ In that
16 regard, AEPCO has suggested that all text after "from customers" be
17 deleted in R14-2-1607.H and R14-2-1607.J be deleted in its
18 entirety.

19 Finally, to avoid needless, time consuming debate over
20 already settled issues, AEPCO has suggested a prudence exclusion be
21 added to R14-2-1607.I:

22 The prudence of an Affected Utilities'
23 investment prior to the effective date of this
24

25 ⁷ See, for example, the testimony of Albert Sterman on behalf
26 of the Arizona Consumers Council, HR TR, p. 2366, l. 24 to p. 2367,
27 l. 2. Also, the testimony of Jack Davis on behalf of Arizona Public
28 Service (Recovery should be from all customers with no exclusion for
self-generators or interruptible power consumers.) HR TR, p. 3690, l.
13 to p. 3691, l. 19.

1 article which the Commission had a reasonable
2 opportunity to evaluate shall not be at issue
in the stranded cost determination.⁸

3 This recommendation is consistent with the high burden of proof
4 required to challenge prior utility investments as currently
5 reflected in the Commission's Rules at R14-2-103.A.3.1.

6 **2. When should "Affected Utilities" be required to make a**
7 **"stranded cost" filing pursuant to A.A.C. R-14-2-1607?**

8 All parties agreed that a utility specific stranded cost
9 filing should be made promptly. However, the calculation of
10 stranded costs is not an easy, nor quick exercise.

11 For AEPCO's part, it can commit to make a stranded cost
12 filing based on the net revenues lost approach no later than ninety
13 days following the issuance of the Order in this proceeding. This
14 would allow Staff and the Commission approximately six months to
15 evaluate this filing prior to the currently scheduled date for
16 competition of January 1, 1999.

17 On behalf of its member distribution cooperatives, AEPCO
18 also recommends that the Commission not impose any mandatory cutoff
19 date for seeking stranded costs. Because the Rules authorize
20 competition in certain distribution related services, there may be
21 distribution related stranded costs. However, their extent will
22 not be known until the transition period is underway.⁹ Commission
23

24 _____
25 ⁸ Based upon a cross-examination question asked of
Mr. Minson, AEPCO has slightly revised this recommendation to allow
Commission review of investments not previously considered.

26 ⁹ See, for example, Breen testimony, HR TR, pp. 154-155;
27 Propper testimony, HR TR, p. 2093, l. 3 to p. 2095, l. 5; and Minson
28 testimony, p. 3018.

1 procedures should be sufficiently flexible to allow timely requests
2 for stranded costs as they arise.

3 3. What costs should be included as part of "stranded costs" and
4 how should those costs be calculated? (By subsequent
5 Procedural Order, this question also includes calculation
6 methodology, assumptions made on market clearing price and the
7 implications of FASB No. 71).

8 AEPCO recommends that it use a "net revenues lost"
9 approach in calculating its stranded costs.¹⁰ As Mr. Edwards of
10 CFC stated:

11 The lost revenues method should be the
12 methodology used to determine stranded costs.
13 The lost revenues approach is particularly well
14 suited for AEPCO since it seeks only to cover
15 its costs and its mortgage coverage
16 requirements.

17 Obviously, this question generated the most controversy and debate
18 during the hearing. However, as previously discussed, most
19 witnesses agreed that this debate did not apply to customer owned,
20 customer run cooperatives like AEPCO.

21 For example, Staff witness Dr. Kenneth Rose agreed that
22 AEPCO's "net revenues lost" methodology designed to cover
23 reasonable operating costs and meet mortgage criteria would be
24 consistent with his "transition revenue" recommendation.¹¹
25 Similarly, Mr. Higgins, on behalf of Arizonans for Electric Choice,
26 agreed that AEPCO's approach to stranded cost recovery would be
27 appropriate for cooperatives:
28

25 ¹⁰ AEPCO Exhibit 1, pp. 10 -11; AEPCO Exhibit 2, p. 7; AEPCO
26 Exhibit 3, pp. 3 - 5; and AEPCO Exhibit 4, pp. 6 - 7.

27 ¹¹ HR TR, pp. 3308 to 3310. Accord: Testimony of
28 Mr. Edwards, AEPCO Exhibit 4, p. 6, l. 32 to p. 7, l. 12.

1 Q. To the extent, Mr. Higgins, that a
2 cooperative were simply to become before
3 this Commission seeking on a prospective
4 basis in relation to stranded costs what
5 it has always sought historically, that
6 being simply to cover its reasonable
7 operating costs and to safely meet its
8 mortgage criteria, avoid default, would
9 you have any objections to that approach
10 for a cooperative in relation to stranded
11 costs?

7 A. I believe that avoiding default is
8 one of the factors that the
9 Commission has already identified in
10 the Rule that -- the Factor No. 3.
11 And I believe that that is an
12 appropriate consideration in
13 designing the stranded costs
14 recovery.

11 Q. And do you understand that the main
12 mortgage criteria are, in fact, the
13 principle criteria which drive a
14 cooperative's rate and, for that
15 matter, stranded cost needs?

14 A. I believe that that is plausible.¹²

15 In summary, the hearing produced generally uniform agreement that a
16 net revenues lost approach as proposed by AEPCO would be
17 appropriate and reasonable for cooperatives.

18 As to the remaining matters posed by this question, they
19 should be appropriately left to utility specific stranded cost
20 proceedings. AEPCO's primary categories of stranded costs will
21 consist of regulatory assets, generation related costs and possibly
22 long-term purchased power obligations. More specificity will be
23 provided in the AEPCO specific stranded cost filing. As to market
24 clearing price, that also may be left to the next stage of this
25 endeavor. In general, however, AEPCO recommends a price which will
26

27 ¹² HR TR, p. 4118, l. 19 to p. 4119, l. 14.

1 reflect longer term considerations so as to minimize stranded
2 costs.¹³

3 Finally, as to FASB No. 71 issues, each accounting
4 witness was consistent that there may be serious consequences
5 associated with a Commission decision indicating that an Affected
6 Utility may not be allowed to recover unmitigated stranded costs.
7 Because of the reasonably strong assurance of stranded cost
8 recovery contained in the current Rules, Affected Utilities like
9 AEPCO have been able to avoid unnecessary write-offs or write-downs
10 of assets which, in AEPCO's case, would worsen its negative equity
11 situation and drive its costs higher.¹⁴

12 AEPCO would strongly urge the Commission to avoid any
13 statements in this Order or Rules' amendments which would produce
14 these adverse results. In particular, the Commission should not
15 accept Staff's recommendation that R14-2-1607 be modified to
16 reflect permissive recovery of stranded costs. As Mr. Minson
17 testified:

18 Staff's sudden and inexplicable reversal of
19 position, both as to the rules it recommended
20 the Commission adopt, as well as positions it
21 articulated in the working groups' final report
22 will complicate, not accelerate, this
23 Commission's stated goal of moving toward
24 competition in the electric industry. Also, if
25 the Commission were to modify its rules as
26 suggested by Staff, the accounting and
27 financial consequences could be significant.
28 Although I am not an accountant, I work with
AEPCO's auditors on its financial statements.
I can confidently predict that a statement by

26 ¹³ See, for example, Mr. Bullis and Mr. Rudibaugh's questions
27 of Mr. Minson at HR TR, pp. 3053 to 3055.

28 ¹⁴ AEPCO Exhibit 4, pp. 2 - 5.

1 this Commission such as the one recommended by
2 Staff that unmitigated stranded costs can be
3 disallowed will have serious and immediate
4 FASB 71 and FASB 121 implications.¹⁵

4 **4. Should there be a limitation on the time frame over which
5 "stranded costs" are calculated?**

5 AEPCO does not believe there should be a Rules'
6 limitation on the time frame over which stranded costs are
7 calculated. This issue should be left to utility specific stranded
8 cost proceedings.

9 **5. Should there be a limitation on the recovery time frame for
10 "stranded costs"?**

11 AEPCO also believes that there should be no generic
12 limitation on the recovery time frame for stranded costs stated in
13 the Commission Rules. Instead, this issue should be left to
14 utility specific proceedings.

15 **6. How and who should pay for "stranded costs" and who, if
16 anyone, should be excluded for stranded costs?**

17 Most of the issues concerning who should pay and who
18 should be excluded have already been addressed in response to
19 Question 1 on suggested amendments. As to "how", in general, AEPCO
20 proposes a "wires" charge that would be passed through its
21 distribution cooperative member owners to their member owners. The
22 wires charge would be coordinated with the standard offer rate to
23 assure that there is no double recovery of stranded costs.¹⁶

24 ¹⁵ AEPCO Exhibit 4, p. 5, ll. 4-16. See also the testimony of
25 Ben McKnight, HR TR, pp. 2400 to 2403.

26 ¹⁶ Mr. Minson's testimony at HR TR, p. 3020. Ms. Pruitt, on
27 behalf of ACAA, indicated that if a stranded cost allowance was made
28 for the standard offer customer to assure that customer did not pay
twice, it would alleviate her concerns about "double dipping". HR TR,
p. 268, l. 15 to p. 269, l. 18.

1 7. Should there be a true up mechanism and, if so, how would it
2 operate?

3 AEPCO believes that a true up mechanism would be
4 appropriate to make sure that its member owners neither under nor
5 over pay stranded costs. Although the precise details of a true up
6 mechanism should be left to AEPCO's specific stranded cost
7 proceeding, AEPCO envisions a clause mechanism similar to its PPFAC
8 with benchmarks and filing requirements established during that
9 proceeding.¹⁷

10 8. Should there be price caps or a rate freeze imposed as part of
11 the development of a stranded cost recovery program and if so,
12 how should it be calculated?

13 As Mr. Minson explained, AEPCO opposes rate caps or price
14 freezes for a variety of reasons:

15 [T]o the extent such a cap or freeze is
16 intended to immunize consumers from the
17 consequences of the market, this would be bad
18 policy. Shifting to competition and market
19 based rates entails risks and rewards.
20 Arbitrary regulatory interference to shield
customers from the consequences of choice is
irrational and does not allow the market to
work as it should. Finally, like most price or
cost control schemes, in my opinion rate caps
or price freezes would be administratively
difficult if not impossible to police and
undoubtedly would create unintended
consequences and gaming possibilities.¹⁸

21 Several other witnesses agreed. For example, Dr. Michael Block of
22 the Goldwater Institute referred to caps and freezes as positively
23

24 ¹⁷ AEPCO is intrigued by the variant of the net revenues lost
25 approach proposed by Arizona Public Service which might alleviate the
26 need for a true up mechanism. It plans to study further this
proposal and if feasible may incorporate it in its specific stranded
cost filing.

27 ¹⁸ AEPCO Exhibit 4, p. 8, ll. 6 - 15.
28

1 a bad thing.¹⁹ Dr. John Landon, on behalf of Arizona Public
2 Service, testified that rate freezes and price caps would be
3 inconsistent with the competitive market.²⁰ On behalf of Staff,
4 Dr. Rose agreed that any kind of price cap would have to make
5 allowance for cost changes in the transmission and distribution
6 rate.²¹

7 The Commission also does not have the jurisdiction to
8 impose either a price cap or rate freeze. Arizona law is clear
9 that public service corporations are entitled to a reasonable
10 return on the fair value of their property determined at time of
11 inquiry. See, for example, Simms v. Round Valley Light and Power
12 Co., 80 Ariz. 145, 294 P.2d 378 (1956); Scates v. Ariz. Corp.
13 Comm'n, 118 Ariz. 531, 578 P.2d 612 (App. 1978); and Consol. Water
14 v. Ariz. Corp. Comm'n, 178 Ariz. 478, 875 P.2d 137 (1993).
15 Obviously, any broad pronouncement by this Commission that a
16 particular rate level is mandatory on a going forward basis would
17 violate this Commission's constitutional duties and would, in fact,
18 be confiscatory.

19 **9. What factors should be considered for "mitigation" of stranded**
20 **costs?**

21 This question has been dealt with in AEPCO's response to
22 Question 1. AEPCO believes that the Rules should be amended to
23 make clear that neither profits nor losses from nonjurisdictional
24 activities should be considered in mitigation of stranded costs.

25 ¹⁹ HR TR, p. 3539, ll. 3 - 15.

26 ²⁰ HR TR, p. 2860, l. 18 to p. 2862, l. 2.

27 ²¹ HR TR, pp. 3320 - 3321.

1 As to the merits, AEPCO has already taken several steps
2 to mitigate its stranded costs although it views those efforts not
3 as "mitigation" but rather as part of its ongoing obligation to
4 provide reliable power to its member owners at the lowest
5 reasonable cost. As explained by Mr. Minson:

6 Let me, if I can, express what AEPCO has done
7 to reduce costs, because I think to phrase it
8 as a mitigation may be out of context. It's
9 our objective to make sure that the rural
customer gets the lowest possible or reasonable
cost and still maintain a financial viable
organization.

10 But in that context, we have renegotiated coal
11 contracts, we have done a special voluntary
12 retirement package, reducing our workforce from
13 315 to now 275. We have renegotiated 85% of
14 our debt portfolio, driving the average cost
15 from 8.1% now down to 6.1% over the last four
16 years. We have tried, although as yet
17 unsuccessfully, to renegotiate some purchase
18 power contracts. Those are a few examples.²²

19 As a result of these and other cost control measures,
20 AEPCO has over the past ten years decreased its Class A member
21 rates by more than 20% and hopes to continue these rate reductions,
22 or at least maintain rate stability, in the future.²³

23 CONCLUSION

24 AEPCO would request that the Commission amend its Rules
25 in the three specific areas identified by AEPCO in its response to
26 Question 1. AEPCO would also request that the Commission allow
27 flexibility for it and its member distribution cooperatives to
28

22 HR TR, p. 3011, ll. 9 - 23.

23 AEPCO Exhibit 3, p. 7, ll. 24 - 27.

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pursue appropriate stranded cost requests in specific subsequent proceedings.

RESPECTFULLY SUBMITTED this 16th day of March, 1998.

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EXHIBIT A

1 MR. HEYMAN: Thank you.

2 HEARING OFFICER RUDIBAUGH: Michael, you
3 were out of the room. Let me go off the record one
4 quick second.

5 (Brief pause.)

6 HEARING OFFICER RUDIBAUGH: Let's take a
7 ten-minute recess.

8 (A recess ensued.)

9 HEARING OFFICER RUDIBAUGH: Michael, we're
10 ready for you.

11

12 CROSS-EXAMINATION

13

14 Q. (BY MR. GRANT) Dr. Cooper, good morning.

15 A. Good morning.

16 Q. My name's Mike Grant. I'm the attorney for
17 the Arizona Electric Power Cooperative, which is a
18 generation and transmission cooperative, and also
19 two of its distribution cooperative members.

20 Are you familiar generally with
21 cooperatives?

22 A. Yes, I'm quite familiar with them.

23 Q. And you know that they are customer
24 owned/customer run organizations?

25 A. Yes.

1 Q. And let me ask you this general question
2 and we can get into more detail if need be.

3 Cooperatives -- I realize that you have
4 dealt generally with utilities in your testimony.
5 By my count, about seven of the 12 affected
6 utilities in the state are cooperatives.

7 Did you have cooperatives in mind in
8 fashioning your testimony?

9 A. Well, cooperatives are different in the
10 sense that as nonprofits, they have not been
11 compensated for that risk. And that part of the
12 argument is different.

13 Second of all, the notion of sharing breaks
14 down in the sense that there are no stockholders
15 with whom to share. So they are quite different.

16 If you will note that the constraint I
17 place on the financial treatment of the utility had
18 to do with the bondholder. And, of course, co-ops
19 are almost 100 percent bondholders.

20 So the ability to -- down and no one there
21 that has a -- is obligated, has a responsibility to
22 step up and absorb some of the stranded costs.
23 That doesn't mean there aren't uneconomic costs,
24 because economic costs are part of the marketplace
25 and not -- you know, they exist. That doesn't mean

1 that ratepayers shouldn't find a way to not pay
2 uneconomic costs. But the solution is just going
3 to be fundamentally different.

4 Q. To the extent that cooperatives on a
5 going-forward basis would be seeking precisely what
6 they have sought in the past, that being basically
7 to cover their operating costs, meet their mortgage
8 covenants, and have sufficient additional funds for
9 purposes such as working capital, those kinds of
10 things, would it be appropriate, in your opinion,
11 for the Commission to allow those on a
12 going-forward basis the same as it has on a
13 historic basis?

14 A. Well, again, I've advocated that the
15 Commission cannot violate the bond covenants,
16 anybody's bond covenants. And so I think that is
17 going to constrain the Commission fundamentally in
18 how they can deal with the co-ops.

19 At the same time, I think the co-ops need
20 to recognize that when we get this vigorously
21 competitive marketplace out here with a fairly low
22 price of electricity, the ratepayers are going to
23 look across the street and say, hey, guys, they're
24 going to want those benefits, too, and downand
25 going to be a tension on the co-ops, and I think

1 the co-ops have recognized that.

2 I don't know that this Commission, because
3 it does not -- it cannot forgive the bonds, for
4 instance, it cannot force bondholders to eat those
5 bonds, etc., that it has the ability to do an awful
6 lot, and so the co-op solution may be in Washington
7 as opposed to -- since that's where the bonds are
8 established, because the state has not underwritten
9 those bonds, the federal government has a role in
10 co-op bonds.

11 So on the one hand, it's completely
12 different. The Commission is going to be hard
13 pressed to solve the problem.

14 On the other hand, I think your ratepayers
15 are going to look out at that market and say: We
16 ought to be able to get some benefits out of it,
17 too.

18 Q. And from the standpoint that the ratepayers
19 elect the members of the board of directors and
20 those kinds of things, they certainly have ways in
21 which to get those messages across to their
22 consumer-owned organization?

23 A. Ultimately, the dollars are -- you can
24 unelect folks, but they're still going to have to
25 deal with those bondholders. So it's different,

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Commissioner - Chairman
RENZ D. JENNINGS
Commissioner
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DOCUMENT CONTROL

IN THE MATTER OF THE COMPETITION) DOCKET NO. RE-00000C-94-0165
IN THE PROVISION OF ELECTRIC) (formerly U-0000-94-165)
SERVICES THROUGHOUT THE)
STATE OF ARIZONA) ARIZONA ELECTRIC POWER
) COOPERATIVE, INC.'S
) REPLY BRIEF

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

INTRODUCTION

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

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

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

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

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

17 Much has been made and much has been written of the
18 "regulatory compact" in this case. AEPCO firmly believes that
19 there is a regulatory compact. In one of many appellate decisions
20 which confirm its existence, the Supreme Court stated, in relation
21 to a cooperative, that by the issuance of a Certificate of
22

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

26 ² "I've advocated that the Commission cannot violate the
27 bond covenants, anybody's bond covenants. And so I think that is
28 going to constrain the Commission fundamentally in how they can
deal with the co-ops." Testimony of Dr. Cooper, HR TR p. 2521,
ll. 4-18.

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

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

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

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

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

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

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

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

7 I. RULES AMENDMENTS.

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

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

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

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

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

9 Resolution: No amendment to the Rule is necessary.

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

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

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

28 . . .

⁶ McKnight Testimony, HR TR pp. 2400-2403.

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

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

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

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

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

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

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

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

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

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

10 Are you aware of that?

11 A. Yes, I am aware of that.

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

16 A. That would -- in general I would agree,
17 yes.⁸

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

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

⁸ HR TR p. 4118, ll. 4-17.

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

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

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

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

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

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

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

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

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

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

38 ¹⁰ HR TR p. 3024, l. 16 to p. 3025, l. 4.

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

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

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

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

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

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

¹¹ HR TR p. 2050, l. 4 to p. 2051, l. 5.

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

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

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

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

20 **CONCLUSION**

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

26
27

¹² RUCO Initial Brief, pp. 26 to 28.

1 RESPECTFULLY submitted this 23rd day of March, 1998.

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