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EXCEPTION

BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
Commissioner - Chairman
RENZ D. JENNINGS
Commissioner
CARL J. KUNASEK
Commissioner

IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.	DOCKET No. RE-00000C-94-0165

Arizona Corporation Commission
DOCKETED

MAY 29 1998

DOCKETED BY

EXCEPTIONS TO THE RECOMMENDED OPINION AND ORDER BY ASARCO INCORPORATED, CYPRUS CLIMAX METALS COMPANY, ARIZONANS FOR ELECTRIC CHOICE AND COMPETITION, MORENCI WATER AND ELECTRIC COMPANY, AJO IMPROVEMENT COMPANY AND PHELPS DODGE CORPORATION

May 29, 1998

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ASARCO, Incorporated, Cyprus Climax Metals Company, Arizonans for Electric Choice and Competition, Ajo Improvement Company, Morenci Water and Electric Company Phelps Dodge Corporation (collectively referred to herein as "AECC"), hereby submit their exceptions to the Recommended Opinion and Order of the Chief Hearing Office Jerry Rudibaugh dated May 6, 1998 (the "Recommended Order").

Primary Objectives Regarding Determination of Stranded Costs Issues

The Recommended Order enumerates six primary objectives that "must be taken into consideration in deciding the overall stranded costs issue." (Recommended Order at p. 8, ls. 11-17). One of the objectives is to minimize stranded costs impacts on customers remaining on standard offer service. (Id. at l. 15). However, it is inappropriate to limit this protection to standard offer customers only. Indeed, if the impacts of stranded costs are not minimized for customers moving to competition, the incentives for selecting competitive service are reduced, or even worse, entirely eliminated. Therefore, the primary objectives that must be considered in determining overall stranded cost issues must include minimizing the impacts of stranded costs on customers electing to take competitive service. In fact, the Electric Competition Rules already require consideration of the impacts of stranded costs recovery on the "effectiveness of competition." See A.A.C. R14-2-1607(I)(1).

Net Revenues Lost Methodology (Option 1)

AECC has several concerns with the Recommended Order's Option No. 1, the utilization of a Net Revenues Lost Methodology. To begin with sole reliance on the net revenues lost approach to determine stranded cost recovery is fundamentally flawed. As the Chief Hearing Officer recognizes, this methodology is premised upon estimates of future market prices that are extremely difficult to predict. (Recommended Order at p. 7, ls. 9-10). As a consequence, inefficient utilities with high administrative and general costs will have the highest stranded costs, a burden that customers will unfairly have to shoulder.

One recommended methodology, a hybrid of the net revenues lost and replacement cost approaches, was specifically designed to eliminate most of the elemental hazards associated with the recommended Net Revenues Lost methodology. (See Arizonans for Electrical Choice and Competition, ASARCO Incorporated, and Cyprus Climax Metals Company's Initial Brief Regarding Stranded Costs dated March 16, 1998 ("AECC Brief") at pp. 11-12.) Utilizing this hybrid calculation methodology, stranded costs are mated on a year-to-year basis during a limited transition period, three to five years, with total stranded costs calculated using a replacement cost evaluation method.[1] Stranded costs, including only the stranded costs associated with that same year of recovery, would be recovered from customers through a transition charge or CTC levied on distribution service. This hybrid methodology, which is comparable to the Chief Hearing Officer's recommended methodology, provides for a decline in the percentage of stranded costs that can be recovered for each successive year of competition throughout the transition period. Moreover, this hybrid methodology calls for annual "true-ups" to correct for deviations in the market price of power. Finally, by capping total stranded costs using replacement valuation, the recommended hybrid approach maintains the advantage of a year-to-year calculation of stranded costs associated with the Net Revenues Lost Methodology set forth in the Recommended Order while simultaneously protecting consumers from open-ended recovery.

The Net Revenues Lost Methodology set forth as Option No. 1 in the Recommended Order is very similar to the hybrid calculation methodology recommended in AECC's Brief. However, there are three areas where the Recommended Order's Option No. 1 differs. First, the Chief Hearing Officer's Net Revenues Lost Methodology leaves open the total amount of stranded costs that can be recovered. A better approach is to limit the recovery of stranded costs to the replacement cost value. In that way, all interested stakeholders, consumers

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[1] The Chief Hearing Officer correctly points out that traditional replacement cost valuation lacks a "true-up" mechanism to correct erroneous assumptions. (Recommended Order at p. 7, ls. 12-13.) However, the net revenues lost/replacement cost methodology eliminates this "disadvantage" by providing for a true-up mechanism.

and Affected utilities, are furnished with greater certainty regarding the amount of stranded costs to be recovered through the CTC. Second, the recommended hybrid methodology initiates recovery of stranded costs for Affected Utilities at a lower level. One hundred percent (100%) recovery, as set forth in the Recommended Order is too high. By granting Affected Utilities the opportunity to recover 100% of stranded costs during the first year of competition, it will be nearly impossible for consumer to realize any savings by entering into a competitive market. It follows that customers will be unlikely to take competitive service. In contrast, by selecting a methodology, like the hybrid methodology recommended in AECC's Brief, that provides an opportunity to recover less than 100% of stranded costs during the first year, customers will be enticed into the competitive marketplace by the promise of lower costs for electric utility service. Perhaps more importantly, Affected Utilities will have a significant incentive to mitigate stranded costs.

Third and finally, Option No. 1 erroneously differentiates between the recovery of stranded costs and recovery of regulatory assets. By treating the recovery of regulatory assets separately, the Chief Hearing Officer's recommended methodology ignores the critical role of the market price for electric power. In short, in the event that market prices are higher than estimated, and Affected Utilities are allowed to recover their regulatory assets separate from the recovery of stranded costs, the Affected Utilities will reap a windfall profits under the recommended methodology.

Regulatory assets are an integral part of stranded costs as recognized in the Electric Competition Rules. See A.A.C. R14-2-1601.8(a). Accordingly, regulatory assets should be included as part of total recoverable stranded costs and Affected Utilities should be allowed an opportunity to recover a percentage (less than 100%) of this total. To the extent it is deemed necessary to recover regulatory assets, Affected Utilities can be authorized to recover either: (1) the designated percentage of stranded costs (including regulatory assets) allowed for that given year; or (2) 100% of regulatory assets, whichever is greater.

Divestiture/Auction Methodology (Option No. 2)

AECC also has several concerns regarding Option No. 2, Divestiture and Auction Methodology. First, the Recommended Order's use of the terms "non-essential generation assets" is confusing. (See Recommended Order at p. 12, l. 17.) Affected Utilities selecting divestiture must be required to sell all assets essential to generation. Otherwise, the utilities may only sell the generation assets likely to bring the lowest price. Option 2's allowance for recovery of 100% of stranded costs is inequitable. If the Affected Utilities are given the opportunity to recover 100% of the stranded costs following the sale of generation assets, they will have no incentive to achieve the highest possible selling price for those assets. Instead, utilities will be indifferent to the sales price and will have no reason to mitigate a generation asset's drawbacks (i.e. renegotiating onerous fuel contracts) passing on such responsibilities to the winning bidder. In the meantime, the Affected Utility will be made whole without performing any mitigation and customers are unlikely to realize any savings from mitigation.

Any proposal regarding the use of the divestiture option must provide for symmetry. Option No. 2 provides that, in the event that divestiture results in negative stranded costs, such amount shall be shared equally between the ratepayers and the shareholders. (Recommended Order at p. 12, ln. 5) This is asymmetrical. Rather than promising recovery of 100% of stranded costs from ratepayers, if ratepayers will receive only 50% of the benefit of negative stranded costs, they should only be responsible to pay 50% of stranded costs.

Furthermore, any utility choosing the divestiture option should be required to file a divestiture plan identifying all quantifiable divestiture-related costs. These costs should be used in the calculation of the minimum bids necessary to effect divestiture without incurring transition costs that would increase the delivered price of power to customers under competition.

Finally, with respect to Option No. 2, AECC strongly supports the Chief Hearing Officer's recommendation not to allow any carrying charges, including, without limitation, rate of return and taxes, on the unamortized balance of stranded costs.

Financial Integrity Methodology (Option 3)

In a transition to a competitive marketplace, there is no reason to guarantee the existence of non-viable utilities that cannot and should not exist in a competitive marketplace. If an Affected Utility lacks the financial viability to enter into and compete in a competitive environment, it can and should divest all its generation assets. Assuming *arguendo* that some mechanism to protect financial viability is appropriate, the Recommended Order's use of "sufficient revenues to meet minimum financial ratios" is too open-ended. (See Recommended Order at p. 13, ls. 1-2.)

Market Price Index

AECC agrees that the Palo Verde Dow Jones Index or the California Power Exchange Index should be utilized as the appropriate starting point for determining the market price index as included in the implementation plans filed by Affected Utilities. (Recommended Order at p. 13, ln. 7.) Thereafter, components of the average retail market price should include the underlying wholesale price of power, plus transmission and a retail mark-up. The appropriate underlying wholesale price should be a blend of spot and long-term pricing which, in-turn, should be marked up to a retail price for the purposes of stranded cost calculations.

Stranded Cost Period Cutoff

The Chief Hearing Officer expresses the need for a reasonable cutoff period for stranded costs and states that the approval date of Electric Competition Rules should be the cutoff date. However, the Recommended Order, on page 14, line 7, provides Affected Utilities an opportunity to recover additional stranded costs incurred up until the date an opinion and order on the issue of stranded costs is issued by the Commission. This conflicts with the "reasonable" December 1996 date for cutting off stranded cost recovery. In fact, since that time Affected Utilities have known of the imminent transition to a competitive marketplace and have had the opportunity to avoid incurring additional costs that could be stranded. In sum, the Chief Hearing Officer is correct: December, 1996 is a reasonable cutoff period for recovery of stranded costs.

<u>Cap on CTC Charges</u>

The Recommended Order does not provide for a cap on the transition charge or CTC. However, a cap limiting the transition charge to an amount no greater than a customer's current contribution to the utility's uneconomic (i.e., stranded) costs is essential. The purpose of a CTC cap is to ensure that the transition charge does not cause the delivered price of power to customers to be higher under competition than it was under regulation.

Incorporating a CTC cap into the design of the stranded cost recovery program means that, for any customer (regulated or competitive), the sum of the transition charge plus delivery charges (i.e., transmission, distribution, ancillary services, systems benefits charge) plus the market price of generation (used in calculating stranded cost) does not exceed the current rates for that customer. The purposes of the CTC cap in this context is to design the stranded cost recovery program in a manner that ensures that the final delivered price to consumers under competition is no greater than under regulation.

Notably, the CTC cap is accomplished not by regulating the price of generation – which will be set by the market; instead, the CTC cap results from the design of the transition charge, which is considered to be no greater than the contribution to stranded costs that a customer currently makes. Moreover, a CTC cap must apply to all customers - small and large. Without such a cap, customers would be exposed not only to market risk but unwarranted regulatory risk in which the obligation to pay a utility's uneconomic cost could actually be increased via the CTC for those electing to take competitive service.

There are serious practical consequences of failing to adopt a CTC cap equally applicable to all customers. For example, if customers were forced to pay a CTC which exceeds their current contribution to the utility's uneconomic costs, they will be subject to a higher delivered price for power while being denied any benefits of competition. This would be a colossal failure for the retail competition program.

Allocation Methodology

Finally, AECC has several concerns with respect to the Recommended Order's treatment of allocation methodology. First, the special nature of interruptible service must be taken into account in determining stranded costs charges (e.g., completely interruptible services should bear no stranded cost burden). Second, the Commission's opinion and order must ensure that a customer's future stranded costs charges are proportionate to the customer's current contribution to the utility's stranded (or economic) costs. Thus, the Electric Competition Rules must be modified at A.A.C. R14-2-1607 to include the following provision:

> Stranded Costs shall be allocated among customer classes in the same manner consistent with the specific Affected Utility's current rate treatment of the stranded asset, in order to effect a recovery of stranded costs that is in substantially the same proportion as the recovery of similar costs from customers or customer classes under current rates.

This will protect all customers from cost-shifting in the design of the CTC. Moreover, the proportion of stranded costs assigned to retail customers should be commensurate with the portion of an Affected Utilities generation plant dedicated to serving retail load (as opposed to wholesale service).

DATED this 29th day of May, 1998.

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