EXCEPTION

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BEFORE THE ARIZONA CORPORATION COMMISSION

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AZ CORP COMMISSION

MAY 29 4 41 PM '98

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Arizona Corporation Commission
DOCKETED
MAY 2 9 1998

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IN THE MATTER OF THE COMPETITION IN THE PROVISIONS OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.

DOCKET NO. RE-00000C-94-0165

CITIZENS UTILITIES COMPANY'S EXCEPTIONS

Citizens Utilities Company ("Citizens") submits its Exceptions to the May 16, 1998, Proposed Order in the above-captioned proceeding ("Proposed Order"). Citizens is aware that the Commission Staff has also been circulating what appears to be the framework for proposed amended restructuring rules and, despite the extremely short notice, has provided preliminary comments on the Staff's framework. Citizens' Exceptions are directed solely to the Proposed Order and should not be construed to in anyway waive any opportunities for Citizens to comment on the Staff's future rulemaking procedure.

Citizens would first like to thank Hearing Officer Rudibaugh for his leadership, stamina and pleasant sense of humor, without which the hearings would have been even longer and more contentious. Further, Mr. Rudibaugh has sifted through an enormous evidentiary record, weighed the evidence against extraordinary public-policy considerations and fashioned a reasoned, well-balanced Proposed Order. However, the final order will require clarification in a few key areas that may otherwise be inconsistent with the six "primary objectives" that Mr. Rudibaugh intended to take into consideration when fashioning his order.

Mr. Rudibaugh identified six primary objectives:

A. Provide the Affected Utilities a reasonable opportunity to collect 100 percent of their unmitigated stranded costs.

B. Provide incentives for the Affected Utilities to maximize their mitigation effort.

C. Accelerate the collection of stranded cost into as short a transition period as possible consistent with the other objectives.

D. Minimize the stranded cost impact on customers remaining on the standard offer.

E. Don't confuse customers as to the bottom line; and

F. Have full generation competition as soon as possible.

Citizens agrees with each objective. But, as it stands, certain portions of the Proposed Order would make Goal A ("a reasonable opportunity to collect 100 percent of their stranded costs") unobtainable. Citizens believes that this result would be inadvertent; nevertheless, the very real consequences would be significant write-offs and likely, protracted litigation that would only delay competition – thereby thwarting Goal F.

<u>Citizens Exception No. 1</u>. The Divestiture Option Would Guarantee Less-Than-Full Stranded Cost Recovery.

As Citizens has made clear in its testimony and pleadings, Citizens favors the Divestiture/Auction Methodology,[1] and is pleased that the Proposed Order also favors this approach. If a utility selected this option, its stranded cost for its generation portfolio would be the "difference between net market value and book value." This stranded cost would be recovered from all connected customers over ten years, but without "any carrying charges on the

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1 Proposed Order, p. 12.

unamortized balance." Unfortunately, because of the time value of money, this would guarantee that the utility would not be able to recover all of its stranded cost.

The time-value of money is a simple concept. It boils down to the notion that a dollar next year (or ten years from now) is worth less than a dollar today. Many of us purchased Powerball tickets last week when the jackpot reached an all-time high of $195 Million. Under the Powerball rules, each purchaser had to select between a 25-year annuity with total payments equal to $195 Million,2 and a lump-sum "equivalent." The Illinois couple that won the Powerball jackpot had selected the lump-sum option, so their award (before taxes) was $104.3 Million. This illustrates the time-value concept: a 25-year annuity is worth considerably less than cash today.

Under the Proposed Order, as written, an Affected Utility would receive whatever is determined by the auction and divestiture to be its stranded cost in ten payments over ten years, without any interest or earnings on the unpaid balance. To keep utilities whole when ordering amortizations of prudent expenses or investments, Commissions have traditionally allowed unamortized balances to earn interest at the utility's authorized return. If we assume that to be 10%, denying any return over a ten-year recovery amortization period would be equivalent to recovering only 63% of the determined stranded costs. Put another way, the divestiture approach would guarantee that 37% of stranded costs would be borne by shareholders, despite the assurance of a reasonable opportunity for their recovery. This is contradictory and, as will be shown below, would lead to immediate write-offs.

There is another issue with the Proposed Order's auction-and-divestiture approach. It states that:

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2 25 payments of $7.7 Million.

> "All customers connected to the Affected Utilities grid shall pay their appropriated share either through a CTC charge or through the standard offer rate.[3]"

Yet, later the Proposed Order states:

> "We have placed a limitation that customers on the standard offer will not receive an increase as a result of stranded costs.[4]"

This is inconsistent and could prevent full recovery of stranded costs.

The problem is that a utility that divests would still have the obligation to provide power to customers that do not elect competitive suppliers. This would be done through unbundled, standard-offer tariffs. To continue to meet its public-service obligations, the utility would presumably have to purchase new resources for these customers that would be recovered through an unbundled, power-supply charge. On top of this would have to be the stranded-cost-recovery charge. As a result, it is very likely that customers would actually pay more during this period.

There is a related problem. It is unclear what is meant by an "increase." From what base would the increase be measured? Would it be the customers' rate on January 1, 1999, the date that the assets were divested, or some other date? Or is this intended to be a moving target, where new rates, which would include the new power supply costs and stranded-cost-recovery charge, could be no higher than what the rates would be if the asset had never been divested?

<u>Citizens Exception No. 2</u>. The Proposed Order Would Require Immediate Write-offs.

The Proposed Order correctly recognizes that "the financial community is looking for assurances that the Affected Utilities will be provided a return on

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3 Proposed Order, p. 12.
4 Proposed Order, p. 18.

and of their investments". 5 The Proposed Order accurately identifies the criteria that must be met for an entity to continue to be able to recognize regulatory assets in its financial statements. However, the potential effects and requirements of Statements of Financial Accounting Standards Nos. 71, 101 and 121 have not been properly interpreted or considered in their entirety.

These key pronouncements apply to **all** the elements of utilities' financial statements, not just the regulatory assets. For example, significant amounts of the equity component of the Allowance for Funds During Construction reside in the balances-of-utility-plant assets. Such amounts are the result of the rate-making process, and are allowed to be reported as assets only because of the assurances of future recovery in rates that have existed under traditional cost-based regulation.6 Despite the clear language of Objective A (that the Affected Utilities be given a "reasonable opportunity to collect 100 percent of their unmitigated stranded costs"), Citizens has significant concerns that, in its present form, the Proposed Order is either ambiguous or contains provisions that will likely result in unintended write-offs. Clearly, if stranded cost recovery results in write-offs, the Affected Utility will not be able to recover 100 percent of its stranded costs.

As clearly presented in the testimony of witnesses Kissinger (TEP), McKnight (APS) and Dabelstein, the continuing applicability of SFAS No. 71 requires that:

(i) rates be designed to recover the respective entity's costs of providing service; and

(ii) it is reasonable to assume such rates can be charged to and collected from customers.

Recent interpretations of SFAS No. 71 have clarified the requirement that cash flows to satisfy regulatory assets must come from regulated revenues, rather

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5 Proposed Order, p. 17.

6 Similar amounts do not appear on the books of non-regulated businesses.

than competitive revenues. This is true even if it is probable that such competitive revenues will be earned by the respective utility. To the extent, rates are not cost-based or that sufficient assurance of future recovery of regulated revenues does not exist, SFAS No. 101 requires the immediate write-off of all regulatory assets. Further, the utility must then perform an analysis for asset impairment as required by SFAS No. 121, and reduce the carrying cost of any affected assets to their fair market value.

While Citizens' investment in Arizona generating assets is negligible, nevertheless it could incur write-offs associated with its regulatory assets and purchased-power agreements. The Proposed Order should be modified to remove any ambiguities and to provide the requisite assurance for future cost recovery to obviate the need for undeserved write-offs.

Citizens applauds the inclusion of options for recovering stranded costs in the proposed order. However, there are deficiencies or ambiguities in each of the three alternatives that could lead to mandatory write-offs for the Affected Utilities.

A key assumption of Option No. 1 is that expected growth of the Affected Utilities will permit an annual 20% reduction in the amount recoverable under the CTC. Such an assumption is unfounded. Citizens has not experienced such growth in its service territory, nor do we believe that any Affected Utility in the State of Arizona has experienced customer expansion of that magnitude or projects such growth. The inclusion of such a growth offset in the determination of recoverable stranded costs adds an element of uncertainty to the likelihood of future cost recovery that will undoubtedly expose the Affected Utilities to mandatory write-offs of regulatory assets and any other assets that are impaired.

With respect to Option No. 2, Citizens has two primary concerns.[7] As written, the Option may force the Affected Utilities selecting this approach to

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7 This option is still Citizens' preferred alternative, despite these accounting concerns.

make unintended write-offs in two ways. First, the provision in Option No. 2 that carrying charges will not be allowed on the unamortized stranded cost balance will likely require write-offs, equal to the difference between the current and net present value of the amount deferred. This writeoff would never be compensated with increased income, because the time-value of the lost earnings would never be compensated. Second, under generally accepted accounting, assets held for sale are to be reported at the lower of their respective net book value or fair market value. The mere act of determining that a sale is appropriate could trigger a writeoff. In theory, this would be compensated by increased income in future years as stranded costs are recovered, but an initial writeoff is possible.

With respect to Option No. 3 for stranded cost recovery, the requirements for continuing application of SFAS No. 71 would clearly not be met. Even if we look beyond the absence of any indication of just what "minimum financial ratios" would be used, this alternative would result in rates not being based on the utilities' specific costs of providing service. Therefore, an Affected Utility electing Option No. 3 would have to abandon SFAS No.71 for financial accounting and reporting.

Citizens' final accounting-related concern is about price caps or rate freezes. The Proposed Order states that any costs which would result in an increase to the standard offer must be deferred and included in future requests for rate relief.8 Once again, this does not comport with the requirements of SFAS No. 71. Under such circumstances, rates during the interim rate freeze/price cap period would not be based on the costs of providing service. Thus, there would be less than the requisite assurance that any amounts deferred would, in fact, ever be recoverable in regulated rates.

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8 Proposed Order, p. 18.

<u>Citizens Exception No. 3</u>. The Divestiture/Auction Option Requires Additional Clarification.

The Divestiture/Auction Option cannot be rushed. The auction must be conducted over sufficient time to prevent Arizona's generation asset from flooding the market (thereby creating a buyer's market) and to allow utilities to schedule the auction around temporary poor market conditions. Citizens suggests that each utility be given two years to conduct the auction from the date the Commission approves the auction procedure.

Stranded costs must also include the costs associated with conducting the auction, such as fix-up costs, commissions, attorneys, accountants and appraisors' fees, and similar costs.

<u>Citizens Exception No. 4</u>. All Consumers Should Bear Responsibility For Stranded Costs.

All consumers should bear some responsibility for the costs stranded when customers take competitive power. It is recognized that some of the costs that are potentially strandable are covered by the rates charged to Standard Offer customers. Nevertheless, for competition to be successful, competition must be at the margin, and those taking competitive power must see the results of their decisions in the total price they pay for electricity. If the ten-year stranded-cost-recovery period under Option No. 2 is less than the revenue periods implicit in the successful parties' bids for the divested assets, the CTC paid by customers taking competitive power could be greater than the power cost savings they realize, thereby creating an economic **disincentive** to switch suppliers. As was recognized by the F.C.C. in the deregulation of the long distance segment of telephone industry, the F.E.R.C. in deregulating gas pipelines, and several other states such as California that are restructuring the electric industry, there is a societal value to be gained by this undertaking -- all consumers should bear some portion of the transition costs. Citizens does not oppose, however, some distinction being made in the CTC charged to Standard

Offer Customers and those taking competitive power supplier, to recognize that the rates charged to the former do reflect the embedded costs of some potentially strandable assets.

<u>Citizens Exception No. 5</u>. 30 Days Is Not Enough Time To Prepare A Stranded Cost Filing.

The Proposed Order would require each Affected Utility to make a stranded-cost filing within 30 days of the date of the Order.[9] This is simply not enough time. Preparing the estimates is a massive undertaking. It is true that some of the preliminary work can commence before the date of the final Order, but the Order will set the actual rules for calculating stranded costs. Once the rules are final, each utility will then have to evaluate its total "generation" portfolio in light of its best forecasts of future delivered power costs to calculate its stranded-cost estimate. Then, following public, evidentiary hearings, the Commission will have to determine each utility's stranded costs and recovery mechanism.

It makes no sense to hurry the utilities to preparing patched-together, rushed filings. This can only prolong the evidentiary hearings and ultimately delay the onset of competition. A more reasonable time, given the magnitude of the effort and the importance of the result, would be 90 days.

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9 *Id.* at 13.

CONCLUSION

Citizens continues to support the rapid transition to a competitive environment. The Proposed Order goes far toward that goal. Again, Mr. Rudibaugh has got all the big issues right. With the incorporation of the few modest clarifications that Citizens offers in these Exceptions, the final Order will allow Arizona to cross the threshold from talking about competition to actually implementing competition.

RESPECTFULLY SUBMITTED this 29th day of May, 1998.

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