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EXCEPTION

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May 29, 1998

Arizona Corporation Commission
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Docket Control Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

ATTENTION: MS. CARMEN MADRID

**RE: Docket No. RE-00000C-94-0165
Competition in the Provisions of Electric Services
Throughout the State of Arizona**

Dear Ms. Madrid:

Enclosed are the original and ten copies of PG&E Energy Services Corporation's Exceptions to Chief Hearing Officer's Recommended Opinion and Order in the above referenced matter.

If you have any questions, please feel free to contact me at (520) 721-1900.

Sincerely,

Lawrence V. Robertson, Jr.

LVR:djb

Enclosures

BEFORE THE ARIZONA CORPORATION COMMISSION

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

Arizona Corporation Commission
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EXCEPTION

IN THE MATTER OF THE COMPETITION) DOCKET NO. RE-00000C-94-0165
IN THE PROVISION OF ELECTRIC)
SERVICES THROUGHOUT THE STATE) PG&E ENERGY SERVICES
OF ARIZONA) CORPORATION'S EXCEPTIONS TO
) CHIEF HEARING OFFICER'S
) RECOMMENDED OPINION AND ORDER
) ON "STRANDED COST"

Pursuant to A.A.C. R14-3-110(B), and the May 13, 1998 Procedural Order issued by the Chief Hearing Officer in the above-captioned proceeding, PG&E Energy Services Corporation ("Energy Services") hereby submits its Exceptions to the Chief Hearing Officer's recommended Opinion and Order on the subject of "stranded cost."

INTRODUCTION

Usually, exceptions to a Hearing Officer's recommendations are written against a background consisting of those recommendations, the hearing record and the position(s) of the excepting party expressed at the time of the hearing and/or in brief(s). In the present situation there is an additional background element which warrants serious consideration. That element is the "stranded cost" portion of the draft Statement of Position distributed by the Commission's Staff on May 19, 1998 on the subject of Retail Electric Competition.

More specifically, on May 19, 1998 the Commission's Staff distributed a seven (7) page draft Statement of Position of the Commission's Staff "on several significant issues related to

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1 electric restructuring." [see page 1] A copy of that draft Statement of Position, together with a
2 one (1)-page transmittal letter from the Acting Director of the Utilities Division, is attached
3 hereto as Appendix "A" and incorporated herein by this reference. One of the significant issues
4 addressed within the draft Statement of Position was the subject of "stranded cost." [see pages
5 1 and 2]
6

7 Normally, a post-hearing development would not warrant Commission consideration
8 within the context of exceptions to a Hearing Officer's recommendations. However, in this
9 instance, the substance of the proposed treatment of "stranded cost" reflected in the draft
10 Statement of Position is supported by substantial evidence in the record of the "stranded cost"
11 hearing presided over by the Chief Hearing Officer. Thus, although the entirety of that particular
12 proposal was not presented or advocated by a given individual hearing participant, it can be
13 lawfully considered and adopted by the Commission as a means for dealing with the subject of
14 "stranded cost."¹ Moreover, as discussed below, Energy Services believes that is precisely what
15 the Commission should do in this instance.
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18 DISCUSSION OF COMMISSION STAFF'S DRAFT STATEMENT
19 OF POSITION ON "STRANDED COST"

20 Attached hereto as additional background information and incorporated herein by reference
21 as Appendicies "B" and "C", respectively, are the Initial Brief and Reply Brief submitted by
22 Energy Services in the "stranded cost" proceeding. As may be noted therefrom, there are a
23 number of areas of similarity between the position therein advocated by Energy Services and the
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26 ¹The May 19, 1998 transmittal letter accompanying the draft Statement of Position indicates that the
27 Commission's Staff intends to docket a final Statement of Position by May 29, 1998. Assuming that schedule is
28 adhered to, the "stranded cost" portion of the Statement of Position would be in a procedural posture where the
Commission could take official notice of it at the time that it considers the Chief Hearing Officer's recommended
Opinion and Order on "stranded cost."

1 "stranded cost" proposal suggested by the Commission's Staff in its May 19, 1998 draft Statement
2 of Position. The following examples are illustrative.

3 First, at page 1 of the draft Statement of Position, the Commission's Staff
4 recommends that the Commission adopt a policy of "encourage[ing] full divestiture of generation
5 assets" in order to accomplish the following policy goals:
6

- 7 "· To avoid vertical and horizontal market power abuse;
- 8 · To provide Affected Utilities an opportunity for full recovery of stranded
9 cost;
- To accurately assess the value of stranded cost;
- To ensure fair and reasonable treatment of all consumers; and
- 10 · To ensure the financial viability of all Affected Utilities." [see page 1]

11 In both its Initial Brief and Reply Brief, as well as through the testimony of its policy witness,
12 Douglas A. Oglesby, Energy Services expressly identified and supported the first four of these
13 "goals" in conjunction with its advocacy of divestiture as the "stranded cost" calculation and
14 recovery procedure the Commission should adopt. [see Energy Services' Initial Brief at page 8,
15 lines 1-24, and Reply Brief at page 2, line 2 - page 5, line 1] In addition, through its support
16 of the second and third goals, Energy Services in effect supported the fifth goal as well by
17 implication.
18

19 Second, the draft Statement of Position does not require that Affected Utilities divest their
20 generation assets. [see page 1] That is a decision left to their management's discretion,
21 recognizing that an opportunity for 100% recovery of unmitigable cost will not be present if they
22 elect not to divest. That is precisely the position Energy Services' advocated at the hearing and
23 in brief. [see e.g. Initial Brief at page 9, lines 1-8 and Reply Brief at page 2, lines 7-15]

24 Third, the definition of "stranded cost" set forth in the draft Statement of Position [see
25 page 1] and that testified to by Mr. Oglesby during his direct and cross-examination are
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1 substantially similar, and include common generation and regulatory asset, employee severance
2 and retraining expense, and cost of divestiture sale components. [see e.g. draft Statement of
3 Position at page 1 and Energy Services' Initial Brief at page 5, line 22 - page 6, line 2]

4 Fourth, Energy Services recommended that each Affected Utility electing to divest should
5 be required to submit a proposed plan of divestiture to the Commission for review and approval.
6 The Commission Staff's draft Statement of Position contains a similar proposal. [see pages 1-2]
7 Even the timing is substantially the same under each proposal. Energy Services recommended
8 at the hearing that all divestiture activities be completed by January 1, 1999. Whereas, the draft
9 Statement of Position provides that "the sale of generating assets shall be completed prior to
10 January 1, 2000 unless otherwise approved by the Commission." [see page 2]

11 Fifth, Energy Services' noted in its Reply Brief that "it is possible to utilize a post-
12 [competition] commencement date true-up procedure under the divestiture approach to address
13 any situations where the net auction proceeds were less than the undepreciated book value of the
14 generation assets in question." [see Energy Services Reply Brief at page 3, lines 5-8] The
15 Commission Staff' draft Statement of Position incorporates this feature in connection with its
16 provision that "a transition charge, subject to true-up, will be estimated and collected beginning
17 on January 1, 1999." [see at page 2]

18 As previously noted, no single "stranded cost" hearing participant advocated a position
19 identical in all respects to the "stranded cost" proposal set forth in the Commission Staff's draft
20 Statement of Position. However, in the case of Energy Services, it is able and willing to support
21 those features which are in addition to its own proposal; and it hereby does so.

22 One such additional feature is the provision in the draft Statement of Position that "no
23 Affected Utility or its affiliate may purchase generation assets at any divestiture auction of any
24

1 Affected Utility," except for good cause shown. [see page 1] [emphasis added] While this
2 position is consistent with Energy Services' general position at the hearing on competition, it is
3 more prescriptively explicit than Energy Services' written position and represents an
4 improvement, which Energy Services strongly supports.

5
6 Similarly, the draft Statement of Position deals with the treatment of special contract
7 customers in relation to "stranded cost" recovery responsibility. This represents a refinement that
8 Energy Services' proposal did not specifically address. Because of (i) the imputation of
9 unrecovered "stranded cost" responsibility to the Affected Utility, as opposed to its other
10 customers, for unrecovered "stranded cost" otherwise attributable to special contract customers,
11 and (ii) the provision that any special contract renegotiations shall explicitly deal with such
12 allocation issue,² Energy Services is able to support this additional feature of the Commission
13 Staff's proposal as well. [see page 2]

14
15 A third such feature in the draft Statement of Position is the provision that, "if an Affected
16 Utility chooses not to divest, the Affected Utility will transfer its generation assets to a separate
17 corporate affiliate at a value determined by the Commission to be fair and reasonable." [see page
18 2] [emphasis added] This approach would appear to effectively address concerns Energy Services
19 expressed with regard to cross-subsidization and the need for a clear line of demarcation between
20 an Affected Utility and any affiliate which might participate in the competitive market. As a
21 consequence, Energy Services is able to support this aspect of the draft Statement of Position as
22 well.

23
24 A fourth additional feature is the provision that an Affected Utility may request

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26
27 ²In this regard, in written comments on the draft Statement of Position filed with the Staff on May 22, 1998,
28 Energy Services has recommended that the explicit allocation requirement apply to all special contracts renegotiated
on or after June 1, 1998.

1 Commission approval to collect transition revenues if (i) said utility can demonstrate divestiture
2 of a particular generation asset is not practical nor in the public interest, and (ii) such transition
3 revenues are necessary to preserve its financial integrity. [see page 2] Because of their nature
4 and location, as well as the sustained customer growth projected for the State of Arizona, Energy
5 Services does not believe difficulties will be encountered by those Affected Utilities who
6 undertake to divest their generation assets. However, it recognizes that the possibility of an
7 exception does exist, and this provision could deal with that type of situation. Accordingly, it
8 would not object to Commission adoption of a "stranded cost" procedure containing such a
9 feature, provided interested persons would have the opportunity to seek leave to intervene and
10 participate in any proceeding before the Commission involving such a request by an Affected
11 Utility.
12

13
14 One final area warrants comment. In its draft Statement of Position, the Commission's
15 Staff has not advocated a particular "stranded cost" recovery mechanism and recovery period. [see
16 page 2] Conversely, Energy Services recommended the use of a system-wide competitive
17 transition charge ("CTC") or "wires" charge and a recovery period on the order of 3-5 years. [see
18 Energy Services Initial Brief at page 9, lines 10-15 and page 11, line 28 - page 12, line 4]
19 Instead, the Commission's Staff has proposed that, at some future date, "the Commission shall
20 determine appropriate stranded cost recovery mechanisms and recovery periods." [see Statement
21 of Position at page 2] Also left unclear is whether such Commission determinations shall be on
22 an industry-wide basis or individually as to each Affected Utility seeking such authorization.
23

24 The draft Statement of Position provides in this regard that "any mechanism used for the
25 recovery of stranded cost shall be competitively neutral." [see page 2] [emphasis added] Because
26 of this requirement, taken together with the five (5) policy goals set forth at page 1 of the draft
27
28

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Statement of Position, Energy Services is able and willing to support the Commission Staff's general position on recovery mechanism and recovery period at this juncture. For, as it stated in its Initial Brief,

"With regard to the subject of calculation and recovery of stranded costs, Energy Services believes it is imperative that the Commission recognize at the outset that the methodologies adopted for each will dramatically impact the ability of new entrants to compete successfully in the Arizona retail electric market. Thus, for example, the Commission must consciously endeavor to avoid the selection of any calculation or recovery methodology which would enable an Affected Utility to over-recover its allowed stranded costs. This includes precluding the recovery, as a part of the Competitive Transition Charge ("CTC") or "wires" charge, of any fixed costs which should be attributed to generation assets or contracts it is relying upon to provide electrical power in the competitive market. The Affected Utilities should be required to compete on the same terms and conditions as the new entrants, with success being determined by those who are the most efficient and economical. Similarly, the Commission should avoid the selection of any methodology that would give Affected Utilities an ability to control and manipulate market pricing signals, or exclusive control over and use of customer-related information. Furthermore, the Commission should not countenance the use of any methodology or practice which creates the potential for or allows cross-subsidization or market power abuse." [see Energy Services Initial Brief at page 6, lines 4-21]

* * *

"Thus, in discharging its responsibilities in this area, the Commission must seek to balance and provide for, to the maximum extent possible, the interests of electric retail customers, Affected Utilities and new market entrants, respectively." [see Energy Services Initial Brief at page 7, lines 24-27]

In summary, in light of the foregoing discussion and considerations, Energy Services is willing and able to support, and does hereby support, for purposes of the instant proceeding, Commission adoption of the Commission Staff's position on the subject of "stranded cost" as reflected in the draft May 19, 1998 Statement of Position.

...
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...

1 The problem with this approach is that it effectively accords equal weighting to each argument
2 that is alluded to, thereby avoiding a true evaluation of the same on both its individual merits and
3 in relation to others. In addition, it precludes consideration of additional arguments advanced,
4 pro or con, with regard to a particular methodology that on the merits individually might
5 outweigh a cited argument relating to another methodology. Finally, the use of such a "filtering"
6 analytical process effectively deprives the members of the Commission of the opportunity to
7 reach their own conclusions(s) as to the merits, or lack thereof, of the arguments advanced in
8 support of the competing methodologies.³ For, as A.C.C. R14-3-110(B) suggests, only "the
9 proposed order and any exceptions filed shall be submitted to the Commission for its
10 consideration." In that regard, the significance of this deficiency in the Chief Hearing Officer's
11 approach is underscored when it is remembered that earlier in his recommended decision he
12 observed that selection of the methodology for calculating "stranded cost" is one of two
13 components of the "primary issue" to be decided. [see Opinion and Order at page 6, lines 18-
14 21]⁴

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17 Second, in discussing the argument against use of auction and divestiture as a calculation
18 methodology, the Chief Hearing Officer cited "the various restrictions that have to be overcome
19 to sell the generation assets." [see Opinion and Order, page 7, lines 17-18] [emphasis added] The
20 tenor of this statement suggests that such restrictions in fact exist, and would either be prohibitive
21 in nature or extremely time-consuming and expensive. Energy Services does not recall any
22 testimony or exhibits of that nature with regard to any of the Affected Utilities. It recalls
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24

25 ³For example, Energy Services advanced several different arguments in its briefs against both the "net revenues
26 lost" calculation methodology and APS's proposed variation. [see e.g. Energy Services Reply Brief at page 5 line
27 15 through page 10, line 23]

28 ⁴The second component is how much of the calculated cost is to be recovered by the Affected Utility.

1 conjectural statements from several witnesses, but nothing based upon known fact. Yet, this type
2 of argument was given apparent equal weighting vis-a-vis arguments against the "net revenues
3 lost" approach which were not cited, but had a demonstrable basis in the record developed
4 through both direct testimony and cross-examination.

5
6 Third, the Chief Hearing Officer has stated that "in the majority of other states that have
7 decided this issue," incumbent utilities have been provided "a reasonable opportunity to collect
8 100 percent of unmitigated stranded costs." [see Opinion and Order, page 8, lines 18-20] Energy
9 Services does not recall any testimony or exhibit(s) to support that conclusion. To its knowledge,
10 no state to date has allowed 100 percent recovery. Illustrative of this is the testimony of Energy
11 Services' witness Oglesby and TEP's witness David Fessler that in California the return on equity
12 on all generation assets was reduced to 90 percent of the embedded cost of debt, which
13 represented approximately a 33 percent reduction in the return on equity. Further, as Mr.
14 Oglesby testified, at least one incumbent California utility was effectively required to forego on
15 a net present value basis a return on its investment in nuclear generation assets.

16
17 Fourth, and as an extension of the criticism discussed immediately above, the Chief
18 Hearing Officer's recommendations with regard to Option No.1 and Option No. 2 do not appear
19 to include any provision for reducing the return on equity for generation assets determined to be
20 eligible for "stranded cost" recovery. A reduction of this nature should be prescribed, even in
21 the event of divestiture, since in all likelihood up to a year may pass before the assets are sold.
22 Inasmuch as the prospect of "stranded cost" treatment increases the likelihood of recovery of the
23 investment in question, the level of risk to the shareholder is reduced. Accordingly, the level of
24 the related return on equity should be reduced as well. Furthermore, there is nothing in the
25 hearing record to support or warrant a period of recovery under Option No. 2 in excess of 5
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1 years, yet one of 10 years has been recommended.

2 Fifth, the word "non-essential" should be deleted from the first sentence describing Option
3 No. 2. [see Opinion and Order at page 12, lines 17-18] It is vague and ripe with potential for
4 controversy. In addition, given the caliber and experience in the electric generation industry of
5 entities likely to purchase generation assets in Arizona through auction and divestiture, there is
6 no reason why "must run" generation units should not be subject to auction and divestiture as
7 well.
8

9 Finally, and more in the nature of clarification, in his discussion of Option No. 2, the
10 Chief Hearing Officer states that

11 "if the resulting customer charge would result in an increase in the standard offer rate, the
12 Affected Utility will have to defer those excess amounts for future periods without any
13 carrying charges." [see Opinion and Order at page 12, lines 22-23]

14 In order to accomplish that which is intended, the language of this sentence should be clarified
15 to provide that the excess amounts so deferred are to be recovered solely from Standard Offer
16 customers, and that none are to be recovered from direct access customers.

17
18 Supportive Comments:

19 As noted at the outset of its discussion of the proposed Opinion and Order, Energy
20 Services believes that the Chief Hearing Officer is to be commended for his professionalism and
21 conscientiousness, and his endeavor to prepare a cogent decision for the Commission's
22 consideration. Energy Services does disagree with some aspects of his approach and his
23 recommendations, and those have been discussed in the preceding subsection. However, it also
24 supports a number of his recommendations. The following examples are intended to be
25 illustrative, but not necessarily all-inclusive.
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1 First, Energy Services supports the Chief Hearing Officer's recommendation that the
2 December 26, 1996 date of Commission adoption of the Electric Competition Rules should be
3 the cutoff date for those costs to be considered for possible treatment and recovery as "stranded
4 cost." [see Opinion and Order at page 13, line 24 - page 14, line 7] He has correctly concluded
5 that "there does not need to be a reasonable cutoff period for stranded costs," and that any post-
6 cutoff costs incurred can be factored into the market price. As Mr. Oglesby observed in his pre-
7 filed direct testimony, since the issuance of the Electric Competition Rules on December 26,
8 1998, the Affected Utilities have been "on notice that any new investment must survive a market
9 test." [see Energy Services' Exhibit No. 1]
10

11 Second, Energy Services strongly supports the Chief Hearing Officers' recommendation
12 of divestiture [Option No. 2] as a methodology to be utilized by the Commission for calculating
13 "stranded cost." [see Opinion and Order at page 11, line 7 - page 13, line 3] Energy Services'
14 arguments in favor of divestiture were discussed at length in its Initial Brief and Reply Brief filed
15 in the "stranded cost" hearing; and, in the interest of brevity, are incorporated herein by reference.
16 [see Appendix "B" at page 6, line 2 - page 10, line 21; and Appendix "C" at page 2, line 2 - page
17 5, line 13, respectively]
18

19 Third, Energy Services also supports the Chief Hearing Officer's recommendation of an
20 option [Option No. 3] to address the maintenance of financial integrity for a given Affected
21 Utility which can demonstrate the requisite special circumstances.⁵ [see Opinion and Order at
22 page 12, line 24 - page 13, line 3] The concept therein reflected and described is similar in
23
24

25 _____
26 ⁵For the reasons discussed in its Initial Brief and Reply Brief, Energy Services strongly opposes the Chief
27 Hearing Officer's recommendation that the "net revenues lost" methodology [Option No. 1] be included among those
28 methodologies to be approved by the Commission for "stranded cost" calculation purposes. [see Appendix "B" at page
9, line 26 - page 10, line 18; and Appendix "C" at page 5, line 15 - page 10, line 23, respectively]

1 purpose and nature to the financial integrity alternative described in the last paragraph of the
2 "stranded cost" portion of the Commission Staff's draft May 19, 1998 Statement of Position for
3 which Energy Services expressed support in the first section of these Exceptions.

4 As Energy Services observed in its Initial Brief,

5 "...it is imperative that the Commission recognize at the outset that the methodologies
6 adopted for each [i.e. calculation and recovery of stranded costs] will dramatically impact
7 the ability of new entrants to compete successfully in the Arizona retail electric market."
8 [see Initial Brief at page 6, lines 5-7]

9 Option Nos. 2 and 3 in the Chief Hearing Officer's recommendations represent an appropriate
10 balancing of the interests of retail electric customers, Affected Utilities and new market entrants
11 in relation to the goal of fostering and furthering retail electric competition; and, thus, should be
12 adopted. Option No. 1, the "net revenues loss" methodology does not. Accordingly, that
13 recommendation should be soundly rejected.

14 Finally, Energy Services supports the Chief Hearing Officer's conclusion and
15 recommendation that the composition of "stranded cost" does not include any costs related to
16 metering, billing and customer services. [see Opinion and Order, Finding of Fact No. 10, page
17 21, lines 7-8] As many participants suggested during the hearing, those costs are properly
18 assigned to the transmission and distribution functions. Hence, the Chief Hearing Officer's
19 recommendation in this regard is correct.

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22 CONCLUSION

23 For the foregoing reasons, Energy Services recommends that the Commission (i) adopt
24 the "stranded cost" portion of the Commission Staff's May 19, 1998 draft Statement of Position
25 as its own for purposes of disposition of the above-captioned proceeding, and (ii) direct the
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1 Commission Staff and the Hearing Division to prepare such rules and regulations, and related
2 opinions and orders, if any, as may be necessary or appropriate in order to implement as soon
3 as practicable said Commission "stranded cost" determination. In the alternative, and only in the
4 event the Commission should determine not to adopt the Commission Staff's draft Statement of
5 Position on "stranded costs," Energy Services recommends the Chief Hearing Officer's
6 recommended Opinion and Order be amended to provide for the deletions and revisions suggested
7 by Energy Services' preceding comments.
8

9
10 DATED this 29th day of May, 1998.
11

12 Respectfully submitted,

13 PG&E ENERGY SERVICES CORPORATION

14 By Lawrence V. Robertson, Jr.
15

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Certificate of Service

I hereby certify that I have this 29th day of May, 1998, served the foregoing Exceptions to Chief Hearing Officer's Recommended Opinion and Order on the following parties or counsel of record in this proceeding who filed Initial Briefs, by mailing a copy thereof, properly addressed with first class postage prepaid to:

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By: Lawrence V. Robertson, Jr.
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APPENDIX "A"

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



JACK ROSE
EXECUTIVE SECRETARY

ARIZONA CORPORATION COMMISSION

May 19, 1998

Dear Stakeholder in Retail Electric Competition:

Enclosed is a copy of Staff's position on some of the important issues of Retail Electric Competition. You might note that the position shown is similar, but not identical, to the position that Staff described in various stakeholder meetings over the past two weeks. Staff's position has changed somewhat, based upon comments from various stakeholders and upon the final changes made to HB 2663.

We would appreciate receiving your comments on this Statement of Position by fax or hand delivery to the Office of the Utilities Division Director by noon on Friday, May 22, 1998. We will be docketing the final Statement of Position by Friday, May 29. We anticipate asking for Commission feedback at a Special Open Meeting scheduled for June 3rd.

Our fax number is (602) 542-2129. The office is on the 2nd floor of the Commission Offices at 1200 W. Washington in Phoenix.

We would appreciate your comments. Thanks.

Ray T. Williamson

Ray T. Williamson
Acting Director
Utilities Division

Statement of Position of the ACC Staff

The following represents Staff's position on several significant issues related to electric restructuring. Implementation of most of these positions will require revisions to the current rules.

A. *Stranded Cost*

The goals of the Arizona Corporation Commission are:

- To avoid vertical and horizontal market power;
- To provide Affected Utilities an opportunity for full recovery of stranded cost;
- To accurately assess the value of stranded cost;
- To ensure fair and reasonable treatment of all consumers; and,
- To ensure the financial viability of all Affected Utilities.

In order to accomplish these objectives, it is the policy of the Arizona Corporation Commission to encourage full divestiture of generation assets. Generation assets include, but are not limited to, generating plants, power purchase contracts, and fuel contracts. Affected Utilities that voluntarily divest all generation assets shall have the opportunity to recover 100% of unmitigated stranded cost. However, Affected Utilities are not required to divest generation assets.

"Stranded Cost" means the verifiable net difference between:

- a. The value of all the prudent jurisdictional assets and obligations necessary to furnish electricity (such as generating plants, purchase power contracts, fuel contracts, and regulatory assets), acquired or entered into ... under traditional regulation of Affected Utilities; and
- b. The market value of those assets and obligations directly attributed to the introduction of competition

In addition, unmitigated stranded cost shall include reasonable employee severance and retraining costs necessitated by electric competition, where not otherwise provided. Unmitigated stranded cost shall include reasonable costs associated with sale of generation assets.

Each Affected Utility choosing divestiture will submit a divestiture plan to the Commission for approval. No Affected Utility or its affiliate may purchase generation assets at any divestiture auction of any Affected Utility. This provision can be waived by the Commission for good cause shown. Each Affected Utility seeking to recover Stranded Cost shall submit a Stranded Cost Recovery Proposal for Commission

approval.

The sale of generating assets shall be completed prior to January 1, 2000 unless otherwise approved by the Commission. A transition charge, subject to true-up, will be estimated and collected beginning on January 1, 1999. Revenues from any such transition charge will be placed in a trust account and dispersed as generation is divested. Interest on such trust account shall be used to mitigate stranded cost.

The Commission shall determine appropriate stranded cost recovery mechanisms and recovery periods. Affected Utilities shall bear the burden of supporting their estimates of unmitigated stranded cost. Any mechanism used for the recovery of stranded cost shall be competitively neutral.

Stranded cost shall be allocated among customer classes in a manner consistent with the respective company's current rate treatment.

Special contract customers will not be assessed an additional charge for stranded cost or transition revenues during the term of the special contract. However, a stranded cost or transition charge for the special contract customers will be imputed to the contracts and borne by the Affected Utility, and not the Affected Utility's other customers. If a special contract is subject to either extensions or renegotiation clauses, the renegotiated contract must explicitly include an allocation for the recovery of any applicable stranded cost or transition charge in the renegotiated terms.

If an Affected Utility chooses not to divest, the Affected Utility will transfer its generation assets to a separate corporate affiliate at a value determined by the Commission to be fair and reasonable. The terms of such transfer shall be approved by the Commission and completed prior to January 1, 2000. Regulatory assets shall be fully recoverable unless there are offsetting stranded benefits associated with generation assets.

If an Affected Utility can demonstrate that divestiture of any particular Generation Asset is not practical and not in the public interest, the Commission in its discretion may provide the Affected Utility transition revenues, if necessary, to preserve its financial integrity, but only if such transition revenues are determined by the Commission to be in the public interest.

B. Affiliate Rules

The goals of the Arizona Corporation Commission are:

- To prevent cost sharing and cross-subsidization between competitive and monopoly activities;
- To facilitate ease of regulatory oversight; and,
- To reduce the regulatory burden on the competitive market.

In order to accomplish these objectives, it is the policy of the Arizona Corporation Commission that the Affected Utilities create separate corporate affiliates for competitive activities and monopoly activities. The Affected Utilities will transfer competitive assets to a separate corporate affiliate at a value determined by the Commission to be fair and reasonable. Costs associated with restructuring the affected utility into separate corporate affiliates shall be borne by the shareholders.

The Affected Utility must offer the same terms and conditions of service to all competitors and their customers as it offers to any of its affiliates and their customers. An Affected Utility shall neither provide, nor represent that it will provide, preferential treatment to its affiliates or its customers as compared to nonaffiliated companies or their customers.

Any activity that creates a potential sharing of costs between the Affected Utility and its affiliate is strictly forbidden unless approved by the Commission. Such activities include, but are not limited to, sharing of plant, capital, equipment, employees, information, and joint purchases.

Joint marketing programs between Affected Utilities and their affiliates are forbidden unless approved by the Commission. No trade, promotion or advertising of an affiliate's connection with the parent utility is allowed unless the affiliate discloses that the affiliate is separate from the Affected Utility.

C. Implementation of Competition

The goals of the Arizona Corporation Commission are:

- To provide the benefits of competition to all ratepayers in a timely manner;
- To ensure a smooth transition from monopoly to competition;
- To ensure that the implementation of competitive services is technically feasible; and,
- To reduce unnecessary burden caused by the transition.

In order to accomplish these objectives, it is the policy of the Arizona Corporation Commission to implement direct access where technically feasible, offer benefits in lieu of competition to customers without direct access, reduce the length of the transition period, and create a Residential Phase-In Program to enable Electric Service Providers (ESP) and residential customers to familiarize themselves with retail electric power competition.

1. Timing and Customer Selection

Customers with load of 1 MW and above will have access to competitive electric power services on 1/1/99.

Customers with load ≥ 20 kW can be aggregated to achieve the 1 MW threshold starting on 1/1/99.

All customers will have access to competitive electric services on 1/1/01.

2. Targeted Rate Decreases

The price of the Affected Utilities standard offer for retail customers who are unable to choose competitive electric generation during the transition period shall be reduced. These rate reductions are to be determined separately for each Affected Utility and are targeted to be in the range of 3%-5%.

3. Residential Phase-In Program

Affected Utilities will offer residential customers an opportunity to participate in a Residential Phase-In Program. 1/2 of 1% of residential customers will have access to competition on 7/1/99. The number of customers will be increased by 1/2 of 1% every quarter through the transition period. Access to the program will be on a first-come first-serve basis.

Affected Utilities will submit Residential Phase-In Program Proposals to the Commission for approval by March 31, 1999.

D. Metering and Billing

The goals of the Arizona Corporation Commission are:

- To ensure vigorous competition in the electric power market;
- To promote efficient consumption of electric power;
- To spur technological innovation;
- To ease the transactional burden of competitive access; and,
- To ensure reliability of the system.

In order to accomplish these objectives, competitive metering and billing services will be offered to customers with access to competitive electric power services.

1. Metering

Competitive metering shall be offered to customers having access to competitive electric power services as of 1/1/99. These services can be provided by the Affected Utility, the Electric Service Provider (ESP), or their Agents.

A Universal Node Identifier shall be assigned for each service delivery point by the Affected Utility whose distribution system serves the customer.

All competitive metering data shall be translated into a consistent, statewide format that can be used by Affected Utilities and the Electric Service Providers. Data translation does not have to occur at the meter. The transmittal of billing data among suppliers will

be via electronic data interface (EDI) data file format.

Competitive customers with an hourly load less than 20 kW will be permitted to use load profiling after the transition period.

2. Billing

Customers having access to competitive electric power services can choose whether bills will be provided by the Affected Utility or the ESP or both.

Functionally, disconnects and connects should be coordinated by the Affected Utility. Only the Affected Utility may order connects, disconnects and reconnects.

Customer specific billing data will only be released to parties to whom customers have given authorization.

All delinquent bills shall be subject to the provisions of the Affected Utility's termination procedures.

E. Local Distribution Company Services

The goals of the Arizona Corporation Commission are:

- To create a safe haven for customers not choosing competitive electric power services;
- To ensure access to electric power for all customers; and,
- To ensure the continued regulation of these services.

In order to accomplish these objectives, an Affected Utility acting as a Local Distribution Company shall continue to offer bundled electric power service, or standard offer, to all customers. This service shall continue to be regulated. In addition, the Affected Utilities shall continue to finance programs through a system benefits charge.

1. Standard Offer

The Affected Utility will provide Standard Offer Service.

Customers can change suppliers at the end of their existing electric service provider's billing cycle. There shall be no additional constraints for a consumer switching to or from the Standard Offer Service.

Subsequent to the transition period, power purchased to serve standard offer customers will be acquired through competitive bid. These contracts shall contain provisions allowing the Affected Utility to ratchet down its power purchases.

The Affected Utility shall be the Provider of Last Resort. Reasonable costs incurred in fulfilling this duty may be recovered through a distribution system-wide tariff approved by the Commission.

2. System Benefits

The Affected Utility shall continue to offer programs, such as low-income assistance, demand-side management, and nuclear decommissioning, financed through a system benefits charge.

F. Transmission and Dispatch

The goals of the Arizona Corporation Commission are:

- To ensure fair and non-discriminatory retail access to the transmission and distribution system;
- To promote the development of a competitive market for retail generation; and,
- To ensure continued system reliability.

Affected Utilities shall provide non-discriminatory open access to transmission and distribution facilities to serve all customers. No preference shall be given to any distribution customer based upon whether the customer is purchasing power under the Affected Utility's standard offer or in the competitive market.

Affected Utilities must join an independent system operator whose activities include, but are not limited to, the following:

1. Short-run reliability;
2. Administration of grid-wide tariff;
3. Managing congestion and establishing congestion pricing;
4. Planning transmission expansion for reliability and commercial needs;
5. Emergency operations;
6. Provision and pricing of ancillary services;
7. Facilitate Alternative Dispute Resolution (ADR) process;
8. Operate the Open Access Same-time Information System (OASIS);
9. Resolve "seams" issues; and,
10. Either develop its own reliability standards or follow WSCC/NERC (NAERO) standards.

Until an independent system operator is created, the Affected Utilities must participate in an independent scheduling administrator whose duties include, but are not limited to, the following:

1. Participate in the determination of Total Transmission Capacity (TTC);
2. Define, review and exercise oversight of committed use;
3. Responsible for Available Transmission Capacity (ATC) calculation;
4. Operate overarching OASIS;
5. Receive copy of transmission schedule;
6. Receive and post curtailment information; and,
7. Provide dispute resolution process for transmission use denials and curtailment orders.

Costs associated with the establishment and operation of the independent scheduling administrator shall be recovered through a distribution charge assessed to competitive customers.

Costs associated with the establishment and operation of the independent system operator shall be recovered from customers using the transmission system, including the transmission owner's customers, through FERC-regulated prices, which are set on a non-discriminatory basis.

The Commission shall determine which generation units are must-run units for distribution reliability and mitigation of market power, and will regulate the price of power from such units.

The terms of the must-run contracts will be finalized prior to the divestiture of the must-run units.

APPENDIX "B"

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BEFORE THE ARIZONA CORPORATION COMMISSION

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

IN THE MATTER OF THE COMPETITION IN) DOCKET NO. RE-00000F-94-0165
THE PROVISION OF ELECTRIC SERVICES) INITIAL BRIEF OF PG&E
THROUGHOUT THE STATE OF ARIZONA.) ENERGY SERVICES CORPORATION

INTRODUCTION

Pursuant to the Chief Hearing Officer’s directive, PG&E Energy Services Corporation (“Energy Services”) hereby submits its Initial Brief in connection with the “stranded cost” hearings recently concluded in the above-captioned proceeding. As requested by Mr. Rudibaugh, the discussion set forth below will be organized so as to address the issues identified in the December 1, 1997 Procedural Order (“Procedural Order”) and the December 11, 1997 First Amended Procedural Order (“First Amended Procedural Order”) in the manner therein presented. In addition to reiteration of the position of Energy Services, as presented through the testimony of Douglas A. Oglesby, Energy Services will also discuss certain of the suggestions made or concerns expressed by others during the course of the hearings.

DISCUSSION

Issue No. 1: Should the Electric Competition Rules be modified regarding stranded costs? If so, how?

Answer: Yes. See discussion below.

A. A.A.C. R14-2-1607 (B) should be clarified to provide that Affected Utilities will be afforded an opportunity, but not a guarantee, to recover legitimate, verifiable, and, non-mitigatable stranded costs. As a number of witnesses have acknowledged during the

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1 hearings, under current regulation in Arizona incumbent electric utilities are not guaranteed a
2 recovery of their costs of doing business. Rather, they have only the right to an opportunity
3 to endeavor to recover such costs through their authorized rates and charges, including a
4 return on their investment. The Commission presumably did not intend to endow them with a
5 higher right or expectation of recovery in conjunction with the transition to retail competition
6 in the generation sector. Nor, as their own policy witnesses have indicated, are they entitled
7 to such an "upgrade." Accordingly, A.A.C. R14-2-1607 (B) should be clarified as suggested
8 above.
9

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11 Incident to such clarification, the Commission needs to consider and resolve the level
12 of recovery of stranded costs to which the opportunity will apply. Energy Services' proposal
13 contemplates an opportunity to attempt to recover 100% of those stranded costs determined to
14 be appropriate for such purpose. However, that proposal is contingent upon the Affected
15 Utility in question electing to divest itself of its generation assets.¹ In the event the
16 Commission should be asked to allow an Affected Utility to utilize a non-market
17 methodology for calculating the asserted value of its stranded costs, different considerations
18 would need to be taken into account. In turn, those considerations might well warrant, if not
19 require, Commission prescription of a lesser level of recovery opportunity (e.g. 50/50). For
20 example, amelioration of what might otherwise be an impediment to or constraint upon
21 market entry by new entrants would be such a consideration.
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24 B. A.A.C. R14-2-1607 (B) should further be clarified to expressly provide that the
25 commencement of stranded cost recovery by Affected Utilities shall be linked to the
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28 ¹ Energy Services' reasons for recommending divestiture are discussed elsewhere in this Initial Brief. See, for example, the discussion under Issue 3(A).

1 introduction of retail competition. As one witness testified, competition is the "reason 'd
2 entre" for stranded cost recovery. Others observed that it is the onset of retail competition
3 which identifies those economic efficiencies which are to be addressed by such a transition
4 mechanism. Clearly, the Commission had such a causal relationship in mind when it issued
5 Decision No. 59943 on December 26, 1996; and the Electric Competition Rules should be
6 clarified to expressly so provide at this time. In addition, the Commission should preserve the
7 right to require the refund of stranded costs recovered if markets are not fully open by 2003.
8

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10 C. A.A.C. R14-2-1607 (J) should be modified to provide that stranded costs
11 approved for recovery shall be recoverable from all retail generation customers who remain
12 connected to an Affected Utility's transmission and distribution system regardless of their
13 source of power. There appears to be a consensus on this proposition among the participants
14 in the stranded cost hearings. The only exceptions should be those currently provided for in
15 A.A.C. R14-2-1607 (J), and such variances or exemptions as the Commission may hereafter
16 provide pursuant to A.A.C. R14-2-1615 (C).
17

18 D. A.A.C. R14-2-1607 (G) should be modified to provide for an explicit date by
19 which Affected Utilities shall file estimates of unmitigatable stranded costs. Such date should
20 be as soon as practicable, and designed to allow the commencement of electric retail
21 competition on January 1, 1999, as currently provided in the Electric Competition Rules.
22

23 E. The Electric Competition Rules may need to be further modified or
24 supplemented once the Commission decides how to resolve various of the issues raised in the
25 Procedural Order and the First Amended Procedural Order. Other participants in the
26 "stranded cost" hearings may propose certain changes or additions of such a nature in their
27 respective Initial Briefs. Energy Services will respond to such proposals, if any, as necessary
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1 or appropriate in its Reply Brief.

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3 In this regard, Energy Services recommends that the Commission supplement the
4 Electric Competition Rules to prohibit an Affected Utility from constructing or owning
5 electric generation power plants on a regulated basis subsequent to any voluntary generation
6 asset sales it may undertake. If an Affected Utility voluntarily retains ownership of plants,
7 then Energy Services recommends the Commission prohibit construction or ownership of any
8 new plants. Such a prohibition, however, would **not** be applicable to such activities of any
9 unregulated and separate affiliates of the Affected Utility.
10

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12 Issue No. 2: When should "Affected Utilities" be required to make a "stranded cost" filing
13 pursuant to A.A.C. R14-2-1607?

14 Answer: See discussion below.

15 The resolution of this inquiry will in large measure be influenced by and dependent
16 upon the manner in which the Commission resolves the questions posed by it in several of the
17 other issues set forth in the Procedural Order and the First Amended Procedural Order.
18 Particularly significant among these are Issues No. 3, 4 and 6 which relate to the
19 identification, calculation and recovery of costs deemed to be suitable for the recovery
20 opportunity. Should the Commission adopt Energy Services' proposal that stranded cost
21 recovery be addressed through voluntary divestiture of generation assets and purchased power
22 agreements, the filing date deadline could be 60 or 90 days from the date of issuance of a
23 Commission Decision based on the recently concluded "stranded cost" hearings. In this
24 regard, as Mr. Oglesby noted in his direct testimony with respect to a related matter, the
25 major impact of generation sales resulting from divestiture could be determined in late 1998;
26 and, thus, the basic design of unbundled tariffs could continue on a separate parallel course.
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1 [See PG&E Energy Services Exhibit No. 1 at page 13, lines 1-2.] Presumably such filing
2 would include information by an Affected Utility electing to divest as to its plans and
3 timetable for sale of the assets in question, including details relating to any auction to be
4 conducted and any releases or consents which might need to be obtained. Conversely, under
5 Energy Services' proposal, those Affected Utilities electing to retain their generation assets on
6 a net depreciated book value basis, with no stranded cost, would so indicate. In any event, it
7 is imperative that the filing deadline established by the Commission be one that is compatible
8 with and in furtherance of the commencement of retail electric competition on January 1,
9 1999.
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13 Issue No. 3: What costs should be included as part of "stranded costs" and how should these
14 costs be calculated?

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

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

22 Answer: As to Issue No. 3 and Sub-Issue No. 3(A), see discussion below. "No" as to
23 Sub-Issue No. 3(B) under Energy Services' proposal.

24 As Mr. Oglesby testified, Energy Services' proposal contemplates nuclear and non-
25 nuclear generation assets, purchased power contracts, regulatory assets, nuclear de-
26 commissioning and one-time generation employee (union and clerical) severance costs as
27 constituting those categories of investment or expenditure suitable for consideration for
28 stranded cost recovery. Depending upon the particular circumstances, employee costs
attributable to retraining might also be suitable for inclusion. Additional categories of costs

1 may be proposed by other participants who file Initial Briefs, and Energy Services will
2 comment upon such suggestions as necessary or appropriate in its Reply Brief.
3

4 With regard to the subject of calculation and recovery of stranded costs, Energy
5 Services believes it is imperative that the Commission recognize at the outset that the
6 methodologies adopted for each will dramatically impact the ability of new entrants to
7 compete successfully in the Arizona retail electric market. Thus, for example, the
8 Commission must consciously endeavor to avoid the selection of any calculation or recovery
9 methodology which would enable an Affected Utility to over-recover its allowed stranded
10 costs. This includes precluding the recovery, as a part of the Competitive Transition Charge
11 ("CTC") or "wires" charge, of any fixed costs which should be attributed to generation assets
12 or contracts it is relying upon to provide electrical power in the competitive market. The
13 Affected Utilities should be required to compete on the same terms and conditions as the new
14 entrants, with success being determined by those who are the most efficient and economical.
15 Similarly, the Commission should avoid the selection of any methodology that would give
16 Affected Utilities an ability to control and manipulate market pricing signals, or exclusive
17 control over and use of customer-related information. Furthermore, the Commission should
18 not countenance the use of any methodology or practice which creates the potential for or
19 allows cross-subsidization or market power abuse.
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22 As Arizona Public Service Company Witness John Landon testified during cross-
23 examination:
24

25 Q. In response to another line of questioning from Mr. Meek, you
26 expressed the opinion that new entrants should be required to
27 compete on their own merits in the competitive market, that the
28 incumbent utility should not be disabled in order to allow new
entrants to compete.

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I'd like to ask you the flip side of that question. And from the Commission's perspective as it is formulating a stranded cost recovery program, are there some things that should be taken into account and be sure to do or not to in order to not tilt the field in favor or in direction of the incumbent utilities?

A. Of course there are things the Commission has to do to make sure that the playing field is not tilted against the incumbent, against the entrants.

Q. And what would those be?

A. I think the primary thing that the Commission has to be concerned with is making sure that there is nondiscriminatory access to essential resources and information so that competitors are, in fact, able to enter the market on reasonably equal terms and conditions with respect to the use of essential facilities.

In addition to that, I think the Commission needs to be concerned with setting up an appropriate mechanism to prevent cross subsidies. I think it would be inappropriate and contrary to both good regulatory and good economic principles for the utility to be able to, in effect, tax its regulated customers, DISCO customers, let's say, in order to subsidize its competitive operations or anything else.

I also think for a variety of reasons that they wouldn't have any great incentive to do that, but I think it is appropriate to set up appropriate mechanisms to make sure that that event cannot occur.

Having accomplished that, I think entry ought to be available to all who qualify and meet whatever standard the Commission may decide to impose on entrants, and I would hope that those standards would be enough to protect the public, but not enough to disable many potential competitors. Because I think the more competitors that are able to enter and the more robust the market is, the better the outcome will be to ratepayers and to the people of the state."

[See Tr. 2877, page 17 – Tr. 2879, page 15.]

Thus, in discharging its responsibilities in this area, the Commission must seek to balance and provide for, to the maximum extent possible, the interests of electric retail customers, Affected Utilities and new market entrants, respectively.

1 Energy Services respectfully submits that its stranded cost calculation and recovery
2 proposal would address and satisfy several of these concerns. First, voluntary divestiture
3 removes the incentives for vertical market power abuse; and the Commission's oversight of
4 the recommended auction process could also address horizontal market power concerns.
5 Second, sale of generation assets at or above net book value would remove the need for any
6 CTC or "wires" charge as to those investments, thereby eliminating the potential for over-
7 recovery as to the same.² Third, removal or reduction of the need for use of a CTC or
8 "wires" charge would also address the barrier to new entry problem which exists when such
9 charge includes recovery of and return on generation facilities an Affected Utility has retained
10 and is using in order to participate in the competitive retail generation market. Fourth,
11 divestiture effectively removes the potential for cross-subsidization of the retained generation
12 facilities by the Affected Utility's transmission and distribution operations. Fifth, divestiture
13 ensures Arizona will have a competitive generation market as a result of stranded cost
14 recovery. Sixth, divestiture is a "real time" means of establishing the market value of a
15 generation asset or purchased power contract; and, that's what the calculation exercise is all
16 about! Finally, as Tucson Electric Power Company Witness Daniel Fessler observed:
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20 "...it sounds to me like there is a great deal of common ground
21 in the statement you just read [quoting from Mr. Oglesby's
22 prepared testimony description of the four basic principles upon
23 which Energy Services' calculation and recovery program is
24 predicated] and what I have opined as my belief as a strategy for
25 this Commission to adopt to bring about a viable and sustainable
26 introduction of competition." [See Tr. 582, lines 16-20.]³

26 ² The over-recovery problem should not exist for regulatory assets, because those values have already been
27 determined by the Commission. While the quantification of nuclear decommissioning costs is less precise, there
28 are guidelines which could be used to minimize the potential for over-recovery of the same.

³ As Witness Fessler further noted, selling electric generation units would be an excellent way of valuing them
for stranded cost purposes. [See Tr. 584, line 21 - Tr. 585, line 5.]

1 Energy Services' proposal does not require mandatory divestiture. Rather, in the event
2 an Affected Utility should prefer to retain its electric generation facilities or purchased power
3 contracts, it has the option to do so. The quid pro quo is that it will forego any claim for
4 treatment of any portion of those assets as "stranded cost." As Witness Fessler acknowledged,
5 Energy Services' proposal reserves to the Affected Utility "an element of discretion" with
6 which to make a business decision as to what to do with such assets. [See Tr. 586, lines 3-9.]
7 Thus, it is the Affected Utility's call as to how to proceed.
8

9
10 Furthermore, Energy Services' proposal addresses the interests of customers and
11 Affected Utilities, respectively, by providing that (i) revenues resulting from sales in excess of
12 net depreciated book value and reasonable costs of sale shall be applied to reduce the amount
13 of any remaining stranded costs; and (ii) any "short fall" resulting from the deficiency
14 between sale proceeds and higher book value shall be recoverable through a CTC or "wires"
15 charge over the recommended four (4)-year recovery period. In addition, Energy Services'
16 proposal provides for evaluation and recovery in the situation where an Affected Utility is
17 unable to dispose of a generation asset (nuclear or non-nuclear).
18

19 With respect to such alternative calculation methodologies as other participants have
20 proposed, Energy Services offers the following preliminary observations. Further and more
21 detailed commentary may be forthcoming in Energy Services' Reply Brief. First, depending
22 upon the circumstances, use of an independent appraisal or a spin-off and related stock
23 valuation may be an appropriate means for establishing a market-based value for purposes of
24 calculating stranded costs. The key characteristic in each of these alternatives is that they are
25 market-based, not administrative cost determination methodologies. Second, Energy Services
26 is firmly opposed to the use of administrative methodologies for stranded cost calculation.
27
28

1 Included among these is the "net revenues lost" approach which several participants have
2 recommended. Given its substantial reliance upon forecasts as to future operating and
3 maintenance costs, market prices and customer load growth, as well as assumptions as to an
4 allowed return on equity, this methodology is fraught with serious problems.⁴

5
6 For example, due to its nature, the "net revenues lost" approach provides no incentive
7 for an Affected Utility to mitigate stranded costs. In addition, it allows recovery of a return
8 on equity on generation which was previously calculated on a different risk analysis basis.
9 More specifically, for stranded cost recovery purposes, the return on equity on generation
10 should be reduced because the risk to the Affected Utility has been reduced.⁵ Furthermore,
11 the "net revenues lost" approach allows for recovery of costs which are not stranded and
12 which instead should be at competitive risk (e.g. market costs). Finally, as other witnesses
13 testified, in addition to the potential for over-recovery, this methodology also contains the
14 potential for overstated stranded costs with an unnecessarily high CTC or "wires" charge
15 which may impair or preclude the ability of new entrants to effectively participate in the
16 competitive market.
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19 Depending upon the discussion set forth in Initial Briefs filed by other hearing
20 participants, Energy Services may further discuss the deficiencies of administrative-based
21 calculation methodologies in its Reply Brief.

22
23 With reference to Sub-Issue No. 3 (B), as Arizona Electric Power Cooperative Witness
24 William Edwards and Tucson Electric Power Company Witness Karen Kissinger

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26 ⁴ Illustrative of such criticisms is the testimony of Commission Staff Witness Kenneth Rose. [See Staff Exhibit
No. 2 at page 3, lines 12-19; and page 6, line 25 - page 7, line 2.]

27 ⁵ Illustrative of recognition of the need for such a realignment was the action of the California Public Utilities
28 Commission when it reduced the return on equity to be allowed on generation, for stranded cost recovery
purposes, to 90% of the cost of debt.

1 acknowledged during cross-examination, there would not be an adverse consequence for
2 Affected Utilities in relation to FAS 71 under Energy Services' recommendation of a 100%
3 structured cost recovery opportunity.
4

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

7 Answer: Yes. See discussion below.

8 Under Energy Services' divestiture proposal, there would not be a need for a
9 forecasted period of calculation in the event of a sale with net proceeds equal to or above net
10 depreciated book value. If the net proceeds were less, then Energy Services proposes
11 recovering the difference between costs and purchased power for meeting Standard Offer for a
12 four (4) year period beginning January 1, 1999. Alternatively, if the Affected Utility elects to
13 retain the asset in question at net depreciated book value, then there is no stranded cost with
14 which to deal. Furthermore, as previously noted, with regard to regulatory assets and nuclear
15 decommissioning expense, the cost calculations have either already been determined or are
16 largely in place at this juncture.
17

18 With regard to any other cost calculation methodology which might be considered by
19 the Commission, Energy Services recommends as a general proposition that the use of any
20 forward looking projections be limited as much as possible, due to the uncertainties and
21 vagaries inherent in such methods. Depending upon the arguments advanced in Initial Briefs,
22 by hearing participants, Energy Services may discuss this issue further in its Reply Brief.
23

24 Issue No. 5: Should there be a limitation on the recovery time frame for "stranded costs"?
25

26 Answer: Yes. See discussion below.
27

28 In connection with its proposal, Energy Services has recommended a recovery period

1 of four (4) years. Even if Energy Services' divestiture proposal should not be selected as the
2 Commission's exclusive or preferred calculation approach, Energy Services still recommends
3 a recovery period not to exceed three (3) – five (5) years. As a number of witnesses testified
4 during the recently concluded hearings, the sooner the transition to a competitive market is
5 completed, the better for all concerned, be they retail electric consumers, Affected Utilities or
6 new market entrants.
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10 Issue No. 6: How and who should pay for "stranded costs" and who, if anyone, should be
11 excluded from paying for "stranded costs"?

12 Answer: See discussion of Issues No. 1 and 3 above.

13
14 Issue No. 7: Should there be a true-up mechanism and, if so, how would it operate?

15 Answer: See discussion below.

16 Energy Services' proposal does not need a true-up mechanism. However, as a general
17 conceptual matter, Energy Services does not oppose the inclusion of a true-up mechanism as
18 part of a stranded cost recovery program, provided certain concerns it has are addressed and
19 provided for. First, the recovery period should still be within the time frame parameters
20 discussed above, namely, three (3) – five (5) years. Second, the presence and operation of a
21 true-up mechanism should not endow the Affected Utility using the same with any
22 competitive advantage vis-à-vis new market entrants with whom it may be competing. Third,
23 use of a true-up mechanism should not be allowed if it has the potential to confuse or
24 intimidate consumers, thereby inducing them to avoid seeking pricing alternatives in the
25 competitive market. For example, a true-up should not be authorized if there is any potential
26 for a customer having to pay more as a consequence of the presence of this type of
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1 mechanism than would otherwise be the case during the transition period. The uncertainty
2 resulting from such a situation could clearly inhibit competition. Finally, any true-up
3 mechanism allowed should be intentionally designed to preclude the occurrence, if not
4 prospect, of over-recovery.
5

6
7 Issue No. 8: Should there be price caps or a rate freeze imposed as part of the development
8 of a stranded cost recovery program, and, if so, how should it be calculated?

9 Answer: See discussion below.

10 Energy Services' proposal does not include a "price cap" or a "rate freeze."
11 However, Energy Services strongly believes that residential and small commercial customers
12 should be protected from utility rate increases during the transition period. Under no
13 circumstances should rates for any customers in any class be increased as a result of stranded
14 cost recovery. If the Commission should conclude a rate cap is necessary to prevent utilities
15 from raising rates, then one should be imposed. Depending on the arguments advanced by
16 other participants in their Initial Briefs, Energy Services may discuss this topic further in its
17 Reply Brief.
18

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21 Issue No. 9: What factors should be considered for "mitigation" of stranded costs?

22 Answer: See discussion below.

23 These factors are discussed at some length in Mr. Oglesby's prepared direct testimony.
24 In the interest of brevity, that discussion is incorporated herein by reference. [See PG&E
25 Energy Services Exhibit No. 1, page 24, line 1- page 26, line 22.] Depending on arguments
26 made in response to this issue by other hearing participants in their Initial Briefs, Energy
27 Services may address this subject further in its Reply Brief.
28

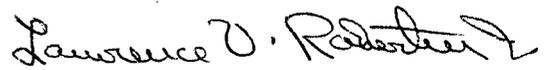
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LEGAL ARGUMENTS

In response to the invitation of the Chief Hearing Officer, Energy Services has no legal arguments it desires to submit in connection with its Initial Brief. It reserves the right to submit legal arguments, if necessary, in connection with its Reply Brief.

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APPENDIX "C"

DIVESTITURE

1
2 For the several reasons discussed in its Initial Brief, Energy Services is recommending a
3 stranded cost calculation and recovery procedure which contemplates divestiture and the use of
4 an auction procedure. [See Energy Services' Initial Brief, page 8, line 1 - page 9, line 18.]
5 Certain of the other hearing participants have registered their objections to this proposal, either
6 directly or indirectly, but their opposition is not well-founded.

7 First, Energy Services' proposal does not contemplate mandatory divestiture.¹ Rather,
8 an Affected Utility would have the option of retaining ownership of its electric generation
9 facilities and purchased power contracts. These would be accorded their present undepreciated
10 book value, and the Affected Utility would forego any claim for treatment of any portion of those
11 assets as "stranded costs." As noted in Energy Services' Initial Brief, the decision as to how to
12 proceed would be in the discretion of the management of the Affected Utility. In this regard, it
13 should be noted that the undepreciated book value option provides for recognition of the then
14 remaining value of the investment of the Affected Utility and its shareholders in the assets in
15 question. Thus, there would not be a confiscation or taking.

16 Second, Energy Services' proposal contemplates that all generation assets would be subject
17 to the prospect of divestiture for an Affected Utility selecting that option. Hence, there is no
18 basis for the criticism that this approach requires the time and effort necessary for making a
19 "bottom-up" determination of the value for each generation asset. Further, as discussed in the
20 testimony of its sponsoring witness (Douglas Oglesby), Energy Services' proposal provides a
21 valuation and recovery procedure in the situation where an Affected Utility is unable to dispose
22 of a generation asset (nuclear or non-nuclear) through auction or negotiated sale.

23 Third, contrary to the contentions of the Commission's Staff, the time necessary to set up
24 the appropriate procedures for conducting an auction need not delay the onset of competition
25

26
27 ¹ However, it should be noted that the Commission Staff has stated that "the Commission's
28 broad constitutional ratemaking and classification authority provide the Commission the necessary
ability to require divestiture." [See Commission Staff's Initial Brief, page 10, lines 12-16.]

1 beyond the currently scheduled January 1, 1999 commencement date. [See Commission Staff
2 Initial Brief, page 10, lines 2-4.] Auctions for a similar purpose have already been successfully
3 conducted in other jurisdictions, and constructive guidance for the Commission and Affected
4 Utilities is readily available by timely examination of those situations. Similarly, there would be
5 no occasion or need for a "fire sale" mentality or atmosphere. Moreover, as Ajo/Morenci/Phelps
6 Dodge witness Alan Rosenberg testified, it is possible to utilize a post-commencement date true-
7 up procedure to address any situations where the net auction proceeds were less than the
8 undepreciated book value of the generation assets in question. [See Tr. 2251, line 20 - Tr. 2259,
9 line 17.] In these circumstances, the potential for over-recovery would not exist, as contrasted
10 with the situation where a true-up is used in connection with an administratively determined cost
11 methodology.

12 Fourth, the fact that certain generation assets of Affected Utilities are either nuclear in
13 nature and/or the subject of a joint ownership arrangement need not preclude effective or timely
14 use of the auction procedure. As noted by Citizens in its Initial Brief,

15 "Capacity and energy from such a facility could be
16 sold on the open market under standard long-term
17 contracts. The total realized from the sales would
18 then be compared to the book value for the facility
19 to determine the stranded costs (positive or negative)
20 associated with the facility." [See Citizens Utilities
21 Company's Initial Brief, page 15, lines 17-21.]

19 In this regard, a variation on the post-commencement true-up procedure described by Dr.
20 Rosenberg could also conceivably be utilized to deal with such delays, if any, which might arise
21 from obtaining the necessary regulatory and private sector approvals.

22 Fifth, there is no basis in fact to support the contentions of the Commission's Staff to the
23 effect that:

24 ". . . even if divestiture helps to mitigate the
25 uneconomic costs by selling assets at greater than
26 book value, the purchasers will nevertheless need to
27 recover their costs of the assets through the rates
28 they charge its customers. . . Thus, while the
utility's uneconomic costs may be reduced, these
costs would simply have to be recovered by the new

1 owners." [See Commission Staff's Initial Brief,
2 page 10 lines 4-9.] [Emphasis added.]

3 In reality, the matter is not that simple. Nor is the cause-effect relationship an automatic given,
4 as the Commission's Staff endeavors to suggest. To the contrary, as Staff Witness Kenneth Rose
5 conceded under cross-examination, the new owners would be subject to the pressures of the
6 competitive marketplace as to the prices they could charge and the costs they could seek to
7 recover for generation services. Thus, the consumers in question would actually receive two
8 benefits under this set of circumstances: (i) a reduction in the Affected utility's "stranded costs"
9 by reason of the above-book value sale of its generation assets; and (ii) the benefits of the
10 competitive marketplace as to future prices for generation service.

11 Finally, there is no demonstrable basis for anticipating that auction sales of generation
12 assets of Affected Utilities in Arizona would not produce the above-book value results
13 experienced to date in other jurisdictions. As Energy Services' Witness Oglesby observed, the
14 characteristics of those assets and the dynamic growth nature of the Arizona market are likely to
15 provide them with certain intrinsic values unique to Arizona. In addition, as observed by Citizens
16 in its discussion of the premiums paid for generation assets sold through auction in other
17 jurisdictions,

18 "Part of the reason these premiums have been earned
19 is linked to investors' expectations about profit
20 potential inspired by the newness of the market
21 opportunity. Coupled with a robust competitive
22 bidding process, these expectations can contribute to
23 higher prices in the auction process. Reports in
24 industry periodicals suggest that divestiture will be
25 good for utilities that undertake it in the near term.
26 Arizona remains on the leading edge of industry
27 restructuring nationwide." [See Citizens Utilities
28 Company's Initial Brief, page 17, lines 13-18.]

24 Thus, Arizona is in a position to take advantage of these circumstances if the Commission acts
25 promptly and adopts the auction approach to "stranded costs" valuation and recovery.

26 In summary, the reasons favoring adoption and use of a voluntary auction procedure for
27 "stranded costs" calculation and recovery purposes far outweigh those submitted against it. As
28

1 previously noted, Energy Services has identified seven of those reasons in its Initial Brief. The
2 Initial Brief of Citizens includes three of those seven in connection with its proposal for use of
3 an auction procedure. [See Citizens Utilities Company's Initial Brief, page 16, line 4 - page 18,
4 line 23.] In addition, Citizens discusses a fourth reason in support of its proposal, which Energy
5 Services would also endorse.² That reason relates to "risk transfer", with respect to which
6 Citizens makes the following observation:

7 **"Risk transfer.** Bidders in the auction would base
8 their bids on what they believe future market prices
9 for power will be. By purchasing generation assets
10 or contracts, successful bidders would assume price
11 forecasting risk, and in particular, the risk that future
12 power prices would be lower than projected. By
13 contrast, under administrative approaches that
14 employ true-up mechanisms, customers would bear
15 the risks of under-forecasting future prices, and pay
16 the differences between established stranded charges
17 and the actual amount of above-market costs on a
18 forward-going basis." [See Citizens Utilities
19 Company's Initial Brief, page 16 lines 11-17.]

15 "NET REVENUES LOST" APPROACH

16 In its Initial Brief, Energy Services discussed several reasons why it is firmly opposed to
17 the use of (i) administrative cost determination methodologies in general and (ii) the "net
18 revenues lost" procedure in particular in conjunction with the calculation and recovery of
19 "stranded costs". [See Energy Services' Initial Brief, page 9, line 19 - page 10, line 18.] Other
20 participants expressed their opposition in even stronger terms in their Initial Briefs. For example,
21 one participant, representing both Affected Utility and industrial consumer perspectives, made the
22 following cogent observation:

23 "Of all the administrative approaches to estimation
24 of strandable costs, the net revenues lost is clearly

25 ² Also, the Initial Brief of the Electric Competition Coalition, Enron Corporation and Enron
26 Energy Services, Inc. ["EEC/Enron"] contains a summary description, by participant and witness,
27 of the degree to which and the circumstances under which those identified do or could support
28 divestiture as a calculation and recovery procedure. [See EEC/Enron Initial Brief, page 6, line
23- page 13, line 3.]

1 the most one-sided in favor of the utilities. This
2 type of approach should clearly be avoided.
3 Otherwise the stranded cost charge will be too high
4 and will have to be recovered over [too long] a
5 period of time and will adversely affect the
6 emergence of competition." [See Ajo Improvement
7 Company/Morenci Water and Electric
8 Company/Phelps Dodge Corporations' Initial Brief,
9 page 15, lines 13-18.]

10 An equally harsh assessment was expressed by the Commission's Staff in connection with its
11 discussion of the attempt by certain major Affected Utilities to advance a methodology for
12 guaranteeing recovery of uneconomic costs:

13 "The utilities do not explain why stranded costs
14 should be granted a higher assurance of recovery in
15 the transition to a competitive market than those
16 same costs would have enjoyed under continued
17 regulation. Lip service is paid to the notion that
18 what the utilities seek is the opportunity to recover
19 stranded costs, but that lip service is belied by the
20 proposals presented. Implementation of a net lost
21 revenues approach, for purposes of determining cost
22 recovery, as presented by APS and TEP, necessitates
23 the leap of faith of assuming that it is possible to
24 determine what revenues would have occurred under
25 the continuation of regulation. And while a true-up
26 mechanism has the comforting attribute of
27 minimizing the risk of over-recovery, it acts as a
28 guarantee of recovery, the likes of which does not
even occur under traditional regulation." [See
Commission Staff's Initial Brief, page 23, lines 20-
28.] [Emphasis in original.]³

In light of these criticisms, it is clearly evident that use of the "net revenues lost" methodology

³ Two additional observations are in order in connection with the Commission Staff's comment on "guarantee of recovery." First, there is a need to reduce the return on equity on generation to be allowed under any "stranded costs" recovery method which may be adopted. That is because the return on equity originally determined in an earlier rate proceeding involving the Affected Utility in question assumed a higher risk as to the prospect of recovery of the underlying capital than will in fact be the case under the "stranded costs" procedure. [See Energy Services' Initial Brief, page 10, lines 10-11; and Footnote Number 5.] Second, the higher the guarantee of recovery under a given methodology, when coupled with the use of a true-up, the lower the return level which should be authorized. For example, if the assurance of recovery is effectively 100%, the return on equity allowed on generation should not be any higher than the 30-year Treasury Bill rate.

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1 for calculation and recovery purposes would not provide for that balancing of retail electric
2 customer, Affected Utility and new market entrant interests, respectively, which the Commission
3 should seek in conjunction with the development of a "stranded costs" recovery procedure. [See,
4 in this regard, Energy Services' Initial Brief, page 6, line 4 - page 7, line 27.]

5 Additional criticisms noted in the Initial Briefs of other hearing participants include the
6 following. First, by its very nature and design, the "net revenues lost" methodology contains the
7 potential for overstating stranded costs. The resulting recovery charge, in turn, can create market
8 entry problems for new competition. While a true-up mechanism can be designed to address the
9 problem of over-recovery prospectively, it cannot compensate for the barriers to market entry
10 which have previously been experienced.

11 Second, as contrasted with divestiture, which reflects actual market place values, the "net
12 revenues lost" methodology places heavy reliance upon long-term forecasts of market prices and
13 generation costs. By their very nature, these are subject to the possibility of error. Depending
14 upon the number, type and magnitude of such error(s), the resulting adverse affects can be
15 substantial for customers and competitors of the Affected Utility in question.

16 Third, the "net revenues lost" approach also requires the use of an economic model.
17 Despite the best of intentions, these models are subject to the prospect of manipulation and
18 misuse, not to mention inadvertent error. Depending upon the circumstances, the resulting
19 distortions can be significant.

20 Fourth, the "net revenues lost" methodology is predicated upon a determination of what
21 the utility's net revenues would have been had it continued to operate in a regulated monopoly
22 environment. However, the purpose of the exercise is to calculate the difference between the
23 book value of generation assets and their market value resulting from competition. The former
24 in effect assumes the continuation of "business as usual." The latter recognizes that is precisely
25 not the case. Thus, there is a serious "conceptual disconnection" between the methodology and
26 the intended result.

27 Finally, the methodology is predicated upon a frozen or static "moment in time."
28

1 Generally speaking, the parameters of that moment are the assumptions made as to forecasted
2 market prices, generation costs, and, perhaps, system load growth. The spatial length or duration
3 is the period of projection selected. As a consequence, there is no provision for reflecting the
4 effects of changes in society, technology or the economy during the intervening months and years
5 as they occur. Any attempt at reconciliation occurs only after the fact, and at the risk of being
6 ineffective or incomplete as to all who may have been affected by the intervening changes.

7 In light of the foregoing considerations, as well as the criticisms raised in Energy
8 Services' Initial Brief, it is apparent the "net revenues lost" methodology is not appropriate for
9 use for the purpose of "stranded costs" calculation and recovery. Indeed, the Commission's Staff
10 conceded as much as it endeavored to distinguish its recommended "transition revenues" approach
11 from that of the "net revenues lost" advocates:

"It is important to recognize the distinction between
the adoption of a method to calculate stranded costs
and the consideration of a method of recovery.
Staff's proposed "top-down" calculation
methodology is very similar to the calculation
methodology suggested by parties sponsoring a "net
revenues lost" approach to stranded cost recovery.
Stranded cost calculations under Staff's proposal
would suffer the same types of infirmities as the
calculations made to support a net revenues lost
approach. The difference is that Staff's approach
does not rely on the calculation of uneconomic costs
as a mechanism to establish recovery levels. The
recovery levels are solely determined by reference to
Commission established criteria to meet financial or
other requirements. Accordingly, the stranded cost
calculations are only a "reference point", useful as a
general guide for considering a utility's competitive
situation, but not directly related to stranded cost
recovery levels." [See Commission Staff's Initial
Brief, page 25, lines 3-13.] [Emphasis added]

ARIZONA PUBLIC SERVICE COMPANY'S PROPOSED METHODOLOGY

24 Arizona Public Service Company ("APS") also endeavored to distinguish the methodology
25 proposed by it from the more traditional "net revenues lost" approach. In advocating adoption
26 of its approach, APS made the following statements in its Initial Brief:
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". . . the APS proposal avoids the forecasting errors and contentious speculation inherent in other applications of the net revenues lost method. . ." [See APS's Initial Brief, page 6 lines 23-25.]

* * *

"The most significant problem with other generic net lost revenues approaches is that they attempt to calculate stranded costs over the remaining life of the generation assets (which could be decades) and involve inevitable and likely significant forecasting errors, both with regard to the market price of generation and future cost of generation." [See APS's Initial Brief, page 7, lines 19-25.]

However, the company "doth protest too much," for its proposed methodology is also subject to some of the same criticisms as the more conventional "net revenues lost" approach. In addition, it warrants some on its own.

More specifically, like the "net revenues lost" approach, APS's proposed methodology adopts a "business as usual" perspective for the intended eight-year period of operation. Thus, it is subject to the previously discussed flaws of (i) a "conceptual disconnection" as between the recovery methodology and its intended purpose, and (ii) the lack of any incentive to reduce generation costs. To the contrary, it would allow APS to recover through prospective annual Stranded Cost Recovery Charge ("SCRC") adjustments revenues intended to reimburse it for the preceding year's costs as incurred. As Citizens has observed, the effect of this would be to "allow APS to recover all above-market costs between now and the year 2006 and then keep all below-market costs [savings] after that date." [See Citizens Utilities Company's Initial Brief, page 19, lines 14-17.]

Assuming that APS's embedded generation cost continues to decline and market prices reach long-run marginal cost by 2006, APS would then be in a position to effectively deter any new market entrants from entering its service area after that date. In the interim, APS would have effectively been insulated from competition by virtue of the fact that any generation customers leaving its system would have had to pay APS an SCRC for their allocable share of its "stranded costs."

1 In addition, as APS Witness Jack Davis acknowledged during cross-examination, by
2 reason of its use of historic data, APS's proposed methodology has a lag of one year in terms of
3 reflecting in the calculation of the SCRC what is actually occurring. [See Tr. 3741, lines 9-15.]
4 Thus, if the market price of power is steadily increasing with the passage of time, and APS's
5 generation costs are steadily declining during that same period, by reason of the use of historic
6 data for the annual SCRC adjustment, APS could actually collect more "stranded costs" revenues
7 than the differential it is actually experiencing in a given year. Hence, APS's proposal appears
8 to be designed to provide it with an advantage over prospective new market entrants both during
9 and after its suggested eight-year transition period. Surely this is not a result the Commission
10 would knowingly sanction incident to the development and approval of a "stranded costs"
11 recovery procedure, particularly where the effect would be to inhibit the emergence of a
12 competitive market at the expense of APS's distribution customers!

13 Furthermore, by including only generation related costs, APS methodology effectively
14 eliminates from consideration any opportunities for mitigation which might exist by reason of cost
15 savings in the distribution sector.

16 Finally, APS's proposal creates an additional problem for prospective new market entrants.
17 The eight-year transition period makes it virtually impossible for new entrants to sign existing
18 APS customers to new long-term contracts, given the uncertainty as to SCRC levels due to annual
19 adjustments based on retrospective analysis of data. Under these circumstances, an APS
20 competitor cannot intelligently offer a fixed total delivered price for any meaningful period of
21 time. In this regard, it is Energy Services' general position that any "stranded cost" recovery
22 period should be on the order of a three (3) to five (5) year time frame, regardless of the
23 calculation and recovery methodology selected.

24 COMMISSION STAFF'S "TRANSITION REVENUES" PROPOSAL

25 The Commission Staff's "transition revenues" proposal does not provide a neat conceptual
26 fit under the analytical framework established in the Procedural Order and the First Amended
27
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1 Procedural Order. To quote the Commission's Staff,

2 "The reason is simple. The transition revenues
3 approach does not require the Commission to make
4 any determination about recoverability of
5 uneconomic costs. The Commission does not
6 conclude that such costs are recoverable, or are not
7 recoverable, or what percentage of such costs are
8 recoverable." [See Commission Staff's Initial Brief,
9 page 7, lines 1-4.]

10 Energy Services' decision to address the Commission Staff's proposal under Issue No. 3(A) is
11 thus admittedly arbitrary. For the reason indicated in the preceding quotation, Energy Services'
12 discussion will also necessarily be brief.

13 More specifically, because the "transition revenues" approach is generic in nature and
14 contemplates further rulemaking proceedings incident to the development of the contemplated
15 "Commission - defined criteria," Energy Services is not in a position at this time to determine
16 its potential effect upon (i) the emergence of a competitive market in the provision of electric
17 generation service or (ii) the ability of new entrants to effectively compete with incumbent
18 Affected Utilities. Rather, Energy Services would need to know more detail, which currently
19 does not exist, in order to offer informed comment.

20 However, at a minimum, Energy Services strongly recommends that the Commission not
21 consider adoption of the "transition revenues" approach if use of the same would delay the
22 commencement of competition in the Arizona retail electric market beyond January 1, 1999. In
23 addition, Energy Services urges that any consideration of that approach include an examination
24 of the possible effects of the same upon the ability of new market entrants to effectively compete.

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

26 Answer: See discussion below.

27 Following consideration of the Initial Briefs filed by other hearing participants, Energy
28 Services desires to supplement the response set forth in its Initial Brief. [See Energy Services'
Initial Brief, page 12, line 16 - page 13, line 5.] More specifically, Energy Services believes that

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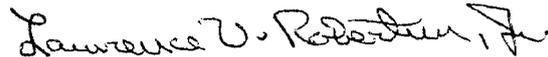
1 a true-up mechanism should not be allowed to provide affected utilities a guaranteed recovery of
2 those "stranded costs" identified as appropriate for recovery. As various Affected Utility
3 witnesses acknowledged while testifying, and as the Commission Staff and Energy Services'
4 Initial Briefs have noted, Affected Utilities are entitled to an opportunity to endeavor to recover
5 such costs, but not a guarantee of recovery. [See Commission Staff's Initial Brief, page 23, lines
6 20-28; and Energy Services' Initial Brief, page 1, line 25 - page 2, line 10.]
7

8 CONCLUSION

9 For all of the reasons discussed in its Initial Brief and this Reply Brief, Energy Services
10 believes that the Commission should issue an opinion and order (i) adopting the "stranded costs"
11 calculation and recovery proposal submitted by Energy Services, (ii) clarifying and modifying
12 its Electric Competition Rules in the manner recommended by Energy Services, and (iii) taking
13 such additional actions as may be necessary to preserve the January 1, 1999 date for the
14 commencement of retail electric competition in Arizona.
15

16 DATED: March 23, 1998

Respectfully submitted,

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Certificate of Service

I hereby certify that I have this 23rd day of March, 1998, served the foregoing Reply Brief on the following parties or counsel of record in this proceeding who filed Initial Briefs, by mailing a copy thereof, properly addressed with first class postage prepaid to:

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