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Mr. Jim Fisher
Senior Policy Advisor
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

RE: DECISION NO. 60977
DOCKET NO. RE-00000C-94-0165

Dear Jim:

This letter is in response to your April 7, 1999, request for information on witnesses in the Stranded Cost hearings held in February 1998.

On the morning of April 9, 1999, I delivered to your office the direct and rebuttal testimony of Staff's witness, Dr. Ken Rose. I also included over 400 pages of transcript with an index of the pages relating to the two topics of concern (Divestiture and Transition Revenues). This index is Attachment 1 to this letter.

On the afternoon of April 9, 1999, I delivered to your office copies of the direct and/or rebuttal testimony of witnesses listed in Attachment 2 to this letter.

In your letter, you requested: "If the Staff recommendation was not the above, please summarize the filed recommendation and explain how the Staff arrived at their June 1998 recommendation."

The summary of Dr. Rose's direct and rebuttal testimony are attached to this letter as Attachments 3 and 4.

To explain how Staff arrived at its May 1998 recommendation will require some historical background.

First, you may recall that when the Retail Electric Competition Rules were adopted in 1996, the Commission established a number of Working Groups, including the Stranded Cost Working Group. Ms. Kim Clark, of Staff, and the Division Director, Carl Dabelstein, led the discussion of that working group.

What needs to be understood is that the "Staff Position" on Stranded Cost has evolved over time. The "Staff Position" has changed over the past 18 months and has been strongly influenced by the opinions and interpretations of the Director of the Utilities Division. I will attempt to show how the position has changed in the chart below.

Term of Office	Director	Position on Stranded Costs
01/30/97 through 12/15/97	Carl Dabelstein	Full Recovery of Stranded Costs
12/16/97 through 02/09/98	David Jankofsky (Acting)	Transition Revenues Approach
02/09/98 through 03/07/98	Morris Wolfe	(No position stated)
03/09/98 - Present	Ray Williamson (Acting)	Position has evolved to the May 1998 Staff Position

You will notice that the change of Division leadership in December 1997 resulted in a 180 degree reversal of direction. Mr. Jankofsky personally interviewed (via telephone) and reviewed writings of a number of potential Staff consultants during the last week of December 1997. Mr. Jankofsky selected Ken Rose of NRRI to present Staff's case in the Stranded Cost hearings.

It was the selection of Dr. Ken Rose and his convincing testimony that led to the Hearing Officer's inclusion of Transition Revenues as one of three options in the May 6, 1998, Proposed Opinion and Order on Stranded Cost.

The Staff Position on the Divestiture/Auction Methodology developed in two ways. First, there was extensive discussion of the issue in written testimony and there was significant cross-examination at the February 1998 hearing.

Second, in April and May 1998, Staff commenced intensive internal brainstorming sessions to develop a "Staff Position on Retail Electric Competition." As part of that effort, Staff developed the position that, in order to limit the potential exercise of market power by the incumbent Affected Utilities, the Retail Electric Competition Rules should include a section on separation of services. This resulted in a proposed new Rule Section 1616 - Separation of Monopoly and Competitive Services.

Then, on May 6, 1998, the Hearing Division proposed three options for Stranded Cost recovery: 1) Net Revenues Lost methodology; 2) Divestiture/Auction methodology; and 3) Financial Integrity methodology. Although Staff was happy to see that Option No. 3 (Financial Integrity) was the Transition Revenues Approach of Dr. Ken Rose, Staff also was concerned that inclusion of Option No. 1 (Net Revenues Lost) would not be a wise idea. In fact, Staff by this time had come to believe that the record in the Stranded Cost proceeding clearly showed that Divestiture/Auction was the most accurate method of valuation of generation assets, and hence, the most accurate determinant of Stranded Costs.

Staff was strongly influenced by the testimony of RUCO's consultant, Dr. Richard Rosen, and others, that led to the conclusion that if the Net Revenues Lost methodology were used, utilities would collect for apparent "stranded costs" in early years while, in fact, over the long run, there were no real stranded costs but rather significant gains in asset values.

So, Staff's support of Divestiture/Auction was in response to the Hearing Division's three-option proposal. Staff continues to support the Transition Revenues approach. Staff believes that another viable approach is using a market-determined asset valuation via Divestiture/Auction.

If you care to discuss this matter further, please feel free to contact me at your earliest convenience.

Sincerely,

Ray T. Williamson

Ray T. Williamson
Acting Director
Utilities Division

RTW:lhh

Enclosures

ORAL TESTIMONY OF STAFF WITNESS DR. KEN ROSE (FEBRUARY 23, 1998)

Divestiture/Auction Issues	Transition Revenues Methodology
pp. 3090 - 3093	pp. 3097 - 3102
pp. 3128 - 3130	pp. 3105 - 3108
pp. 3138 - 3147	pp. 3114 - 3126
pp. 3206 - 3208	pp. 3180 - 3192
pp. 3235 - 3238	pp. 3193 - 3198
pp. 3247 - 3262	pp. 3234
pp. 3381 - 3385	pp. 3239 - 3240
	pp. 3263 - 3264
	pp. 3310 - 3314
	pp. 3339 - 3345

DIRECT TESTIMONY OF DR. KEN ROSE (JANUARY 21, 1998)

Divestiture/Auction Issues	Transition Revenues Methodology
--	pp. 16 - 17

REBUTTAL TESTIMONY OF DR. KEN ROSE (FEBRUARY 4, 1998)

Divestiture/Auction Issues	Transition Revenues Methodology
pp. 4 - 9	pp. 2 - 4

ATTACHMENT 2

WITNESSES WHO TESTIFIED TO THE DIVESTITURE OR TRANSITION REVENUE ONLY METHODOLOGIES

Date Testified	Auction/Divestiture Methodology	Filed Testimony	Transcript Volume & Page
2/17/98	Dr. Richard Rosen (RUCO)	Rebuttal	VI, 1801
2/17/98	Alan Proper (Navopache Elec Coop)	Direct	VI, 2085
2/12/98	Douglas Oglesby (PG&E Energy Services)	Direct	IV, 1249
2/27/98	Dr. Douglas Nelson (Electric Competition Coalition)	Direct	XIII, 4201
2/27/98	Kevin Higgins (AECC, et al)	Rebuttal/2nd Rebuttal	XIII, 4012
2/18/98	Dr. Alan Rosenberg (AECC, et al)	Direct	VII, 2187
2/23/98	Dr. Ken Rose (ACC Staff)	Rebuttal	See Attachment 1
2/12/98	Rick Gilliam (Land and Water Fund of Rockies)	Direct	IV, 1148
2/11/98	Mona Petrochko (Enron Energy Services)	Direct	III, 825

Date Testified	Transition Revenues Only Methodology		
2/23/98	Dr. Ken Rose (ACC Staff)	Direct/Rebuttal	See Attachment 1

Testimony of Dr. Kenneth Rose
Summary

The Staff believes that as competition in generation develops, the competitive market will provide a more accurate and objective basis to determine the value of generation assets. The fair value standard in Arizona is meant to mimic a competitive market and allows the Commission to use a valuation method that most closely and accurately approximates a market value. The Staff does not accept the argument there is now or in the past a contract obliging the people of Arizona to pay for uneconomic costs. The term regulatory compact, properly understood, does not refer to an implied, implicit, or explicit contract. The Staff does not believe that the "social compact" is now, or has ever been, a contract guaranteeing the utility a perpetual monopoly, freedom from competition, or full cost recovery.

The Staff believes that allowing recovery of uneconomic costs from customers will have a significant negative impact on the development of a competitive generation market. In particular, there are three ways that recovery can distort a competitive outcome. First, recovery will act as a barrier to entry to and exit from the generation market. Second, recovery of uneconomic costs reduces the incentive to mitigate and reduce uneconomic costs. And third, recovery creates an asymmetry of risk and reward that can distort the competitive market. In general, the more uneconomic costs that are recovered, the greater the distortion of the market.

In a competitive market, inefficient and obsolete practices and firms are either eliminated and replaced with more efficient and superior firms or forced to redirect their efforts to become more efficient and better managed. Overall this results in society's limited resources being used in the most productive manner. This limits waste and strengthens the overall economic health of the country. "Bailing out" a firm that faces possible losses hampers this screening process of a market economy. As a result, recovery of uneconomic costs reduces overall economic efficiency and impedes the development of a competitive generation market.

There are three general types of uneconomic costs: (1) costs related to the generation of electricity, or "production costs," (2) "regulatory assets" that are currently carried on the utility's books, and (3) public-policy obligations that a utility may have been required to support by state or federal law or regulation. Only the first two are of major importance in this proceeding.

Of the several ways to estimate the first type of uneconomic costs, potential production costs, the Staff believes the "top-down" approach is a satisfactory approach. This approach projects the net present value of the difference between the generation revenues that would be received if traditional regulation continued and the projected revenues expected with competition. However, the Staff believes that this approach is only appropriate for estimating the size and direction of uneconomic costs of affected utilities in Arizona. The result of the analysis should not be used to determine an amount of uneconomic cost that should be recovered from customers. The Commission should decide the amount of "transition revenues," if any, that are needed to meet predetermined criteria set by the Commission.

With respect to recovery of regulatory assets, Staff believes that post-in service Allowance for Funds Used During Construction (AFUDC) should generally be classified as production assets for purposes of the top-down approach. This is because AFUDC is indistinguishable from other plant costs, and revenues from plant are production revenues that can be recovered through the market. In addition, regulatory assets pursuant to FAS 109 should be classified as production costs as well. These regulatory assets are customer receivables for future income taxes. Regulatory assets that should be specifically considered for recovery are those, not otherwise dealt with above, which were explicitly created and booked as a direct result of an entry or order of the Commission.

Since the recovery of uneconomic costs distorts the development of a competitive market, the time frame for recovery should be as short as possible. The Staff recommends that, if recovery is allowed, the recovery time frame, or transition period, be five years or less. Any allowed transition revenues should be recovered through a "non-bypassable" customer or "wires" charge. This could be in the form of a surcharge added to the distribution charge for all distribution customers.

The question of whether there should be a true-up mechanism depends on how the Commission addresses the recovery of uneconomic costs. The closer to complete recovery of uneconomic costs the Commission decides to allow, the greater the need for a true-up mechanism. Since there will inevitably be errors in the forecast of uneconomic costs, a true-up is needed to reconcile the difference between the actual amount and the amount recovered from customers and to prevent customers from paying too much. However, the need for a true-up diminishes as less recovery of uneconomic cost is allowed. If the Commission allows only a portion of the uneconomic costs, then there is little need for a true-up mechanism.

The Commission may consider a price cap as a safeguard against the possibility of the components of the unbundled rate totaling more than the old tariff. That is, to ensure that the sum of the generation price, the transition revenues allowed, transmission and distribution charges, and charges for other services does not exceed the customer's former tariff. A price cap or freeze, if used, should only exist for the transition period if uneconomic costs are being collected from customers.

A much more robust incentive to ensure mitigation and reduction of uneconomic costs than any accounting or auditing means is to not allow, and certainly not guarantee up-front, full recovery of uneconomic costs. This would be more consistent with the efficiency goals of moving to a competitive generation market and would be less costly administratively.

Finally, the Staff does not believe that securitization of uneconomic costs is in the best long-term interest of Arizona customers or the development of a competitive market since it results in a significant transfer of risk from the utility to customers.

RECOMMENDATIONS

The Staff, through its witness, Dr. Kenneth Rose, is recommending that the Commission adopt a "transition revenues approach" which requires the Commission to determine specific criteria for allowable recovery of the potential competitive losses. At the time that the Commission determines the specific criteria to apply to the Affected Utilities' potential recovery of competitive losses, accounting implications will be identifiable. Until that time, one is only able to speculate on the accounting implications because the total regulated cash inflows is yet to be determined.

SUMMARY OF REBUTTAL TESTIMONY OF DR. KENNETH ROSE

There are four issues addressed in this rebuttal testimony. First, Staff reiterates its position that while it favors a top-down approach to estimate uneconomic costs, this estimate should only be used to indicate the size and direction of the competitive gain or loss in Arizona. If the Commission decides to allow recovery of production uneconomic costs it should be through a "transition revenue" mechanism discussed in the direct testimony that is based on a specific criteria set by the Commission.

Second, Staff does not believe that the Commission should determine up front a percentage of the predicted uneconomic costs that will be allowed for recovery. There is little economic basis for determining the "correct" percentage. Consequently, it will be difficult to determine and likely result in a protracted process to determine it. Third, some witnesses testified that customers who do not choose an alternative supplier should not have to pay for uneconomic costs. The reason for the concern is that customers that leave the utility will not be required to pay or that a broadly defined transition charge will be added to the current rate. Staff believes that its transition revenue and price cap approach will avoid both these possibilities. This is because all distribution customers will pay the transition charge independent of the supplier and the price cap will ensure that no retail customer pays more than their current rate.

Finally, Staff challenges the view that a sale or auction is the best means to value utility assets for purposes of determining uneconomic costs. An unintended consequence of a sale or auction is that the market price may be higher than without the sale or auction. As a result, the apparent "savings" will be paid back by customers over time in the form of higher market prices. Therefore, this option cannot be justified based on only an argument that it will reduce uneconomic costs. If recovery of uneconomic cost is limited, then the utility will have an incentive to decide voluntarily whether to sell its assets based on the company trying to minimize its uneconomic costs. There may be other reasons to require divestiture of generation assets, but reducing uneconomic costs should not be considered one of them.