



Transcript Exhibit(s)

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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. U-0000-94-165
THE PROVISION OF ELECTRIC SERVICES)
THROUGHOUT THE STATE OF ARIZONA.) **DIRECT TESTIMONY OF**
) **DANIEL WM. FESSLER**
)
_____)

On Behalf of
TUCSON ELECTRIC POWER COMPANY

JANUARY 9, 1998

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1 **INTRODUCTION AND PURPOSE**

2 **Q1. Please state your name, affiliation and business address.**

3 A. My name is Daniel Wm. Fessler. I am a partner in the law firm of LeBoeuf, Lamb, Greene &
4 MacRae. My address is One Embarcadero Center, San Francisco, California 94111.

5 **Q2. Please describe your education and professional experience.**

6 A. I graduated from Georgetown University in 1963 with a Bachelor of Science Degree in
7 Foreign Service. In 1966, I received an LL.B. from Georgetown University Law Center. In
8 that same year I was admitted by examination to the Wyoming Bar. In 1971, I was awarded
9 a Doctorate in Juridical Science (S.J.D.) from the Graduate Division of the School of Law,
10 Harvard University. My dissertation was on due process requirements in administrative
11 proceedings. From 1970 through 1994, I was Professor of Law, University of California,
12 Davis where I taught classes in Contracts, Securities Regulation, Corporations, Partnerships,
13 Limited Partnerships and Joint Ventures, and a seminar in administrative law. I have also
14 served as a Visiting Professor of Law at the University of Virginia, the University of Texas,
15 the University of Georgia and the University of California, Los Angeles. Most recently,
16 during my tenure on the California Public Utilities Commission, I taught contracts and
17 business organizations at Law at Boalt Hall, the Law School of the University of California,
18 Berkeley. I assumed the status of a professor emeritus in June, 1994.

19 In 1970 I became a Fellow of the Center for Urban Studies at the Massachusetts
20 Institute of Technology and Harvard University. I represented the Center in the landmark
21 service equalization suit, *Hawkins v. Town of Shaw*, 461 F.2d 1171 (1972). Two years earlier
22 I served as co-counsel for the National Center of Education in Law and Poverty of
23 Northwestern University in the Supreme Court litigation which defined minimal due process
24 guarantees in administrative hearings. The case was *Kelly v. Goldberg*, 397 U.S. 254 (1970).

25 I have held various state and federal government positions, including a six-year
26 appointment (1991-1996) to the California Public Utilities Commission where I was elected
27 President of that Commission from December 1991 through April 1996. The Commission
28 regulates the reliability, safety, and economic terms of service for investor-owned utilities in
29 the fields of energy (electricity and gas), telecommunications, water and transportation. I
30 was also appointed by Governor Wilson to a four-year term on the California Transportation

1 Commission from March 1991 to January 1, 1995 and to the California High Speed Rail
2 Commission from March of 1994 until December 1996 when the mandate of that
3 Commission was discharged.

4 In March, 1997, I joined the law firm of LeBoeuf, Lamb, Greene & MacRae as Of
5 Counsel to their national and international Utility and Energy Practice. I was elected a
6 partner in the firm in December, 1997, effective January 1, 1998. LeBoeuf is headquartered
7 in New York City and is one of the preeminent legal advisors on matters affecting public
8 utilities. LeBoeuf has a significant national and international practice representing both
9 government and private sector clients in regulated industries, particularly energy and utilities,
10 insurance, banking, financial services, telecommunications and transportation.

11 **Q3. On whose behalf are you appearing in this proceeding?**

12 A. I have been asked by Tucson Electric Power Company ("TEP") to share my experience with
13 electric restructuring in California as it may pertain to the issues facing the Corporation
14 Commission and the people of Arizona.

15 **Q4. What is the purpose of your testimony?**

16 A. To respond to the questions propounded by the Commission in the Procedural Order¹ and
17 First Amended Procedural Order² insofar as they relate to issues surrounding the recognition,
18 calculation and apportionment of stranded costs, liabilities and their recovery by the affected
19 utilities in general and Tucson Electric Power Company in particular.

20 **Q5. How is your testimony organized?**

21 A. To better discuss the stranded cost issues framed by the Commission, I should set my
22 remarks in both a personal and institutional context. From a personal perspective, I will draw
23 on my experience as a student of the duty to serve, a subject upon which I have published
24 several articles and co-authored a book.³ I will also be basing my opinions on stranded cost
25 issues identified in the Procedural Orders and on experience formed during my service as a
26 member of the California Public Utilities Commission. That six-year service also sets the
27

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29 ¹ Order dated December 1, 1997.

² Order dated December 11, 1997.

30 ³ Haar and Fessler, *The Wrong Side of the Tracks*, Simon and Schuster, 1986, republished in paperback as *Fairness and Justice: Law in Service of Equality*, Touchstone Press, 1987.

1 institutional context for it centers on the restructuring debate which occurred in California
2 between 1992 and 1996.

3 I hope that the members of the Commission find it most convenient if I organize my
4 thoughts in the following fashion.

- 5 • I would like to begin with a brief overview of both the process and outcome of the
6 restructuring debate pursued during my tenure as President of the Commission and
7 Assigned Commissioner in both our rulemaking and investigation.
- 8 • I will then turn to the question of the existence “yes” or “no” of a social contract
9 between the State of Arizona and the investor owned entities identified as the
10 “affected utilities” in this Commission’s Procedural Orders.
- 11 • Lastly, I will address the specific questions propounded by the Commission dealing
12 with stranded costs, liabilities and benefits.

13 **Q6. Before you begin please elaborate on your professional experience and why it qualifies**
14 **you to provide an opinion on the Corporation Commission’s deliberations on electric**
15 **restructuring and the stranded cost issues addressed in this hearing.**

16 **A.** During my six-year term on the California Commission we originated in North America a
17 debate over restructuring the electric service industry which had begun in Chile and been
18 carried forward in England and Wales. Our motive for examining the innovative
19 restructuring in those jurisdictions was the worst economic crisis experienced in California
20 since the Great Depression. The end of the Cold War, the demise of the USSR, and the
21 massive deficits of our own federal government combined to bring the defense industry to an
22 abrupt winding down which, in turn, set off a chain reaction of plant closures, project
23 cancellations and layoffs. Before it bottomed out sometime in 1995, California shed
24 hundreds of thousands of jobs with the consequence that we were forced to examine virtually
25 every aspect of our economic circumstances.

26 The Commission’s efforts to respond to this challenge are well known within the
27 ranks of our fellow regulators and have been alternatively damned and praised by both utility
28 and non-utility participants in the industry. Suffice it to say that I was the President of the
29 Commission during a period marked by more than one hundred hours of public hearings; the
30 assigned commissioner who issued the procedural orders which paced our movement toward

1 the enunciation of an industry structure which would defend the public interest in the context
2 of competitive discipline and significantly revised regulation; and the author of the majority
3 opinions in May, 1995 and December, 1996 which charted the reforms which the State of
4 California has been implementing since that date. As envisioned in those orders and
5 reflecting the labors of my former colleagues and successor, the Power Exchange and
6 Independent System Operator were to begin functioning in the public interest on January 1,
7 1998. On December 29, the Independent System Operator cited a number of technical
8 difficulties in announcing that it could not meet that deadline and setting a new
9 implementation date of no later than March 31, 1998.

10 **PART ONE: THE CALIFORNIA RESTRUCTURING**

11 **Q7. You have indicated that the California Commission acted in the context of an economic**
12 **crisis, could you briefly elaborate?**

13 **A.** Yes, I have just indicated the magnitude of our job loss. With full realization that we had
14 neither the desire nor the capacity to reinvigorate the defense industry, the task of our citizens
15 in general, and public office holders in particular, was to staunch the hemorrhaging of what
16 remained of California's industrial, agricultural and commercial sectors. Ongoing
17 assessments pointed to many factors which contributed to an adverse business climate. To
18 my mind, one fell squarely within the responsibility of the Public Utilities Commission: the
19 cost of energy. In 1992 one of the most distressing features of our economy was the price
20 we were paying for electricity: fully 50% above the national average. The politics of this
21 situation were at once simple and complicated. Our relatively mild climate and consequent
22 light consumption patterns meant that the average California householder paid utility bills at
23 about the national average. Seen from their perspective we had a problem (everyone would
24 like lower utility bills) but no crisis. But the relative contentment of the average householder
25 was of no comfort to anyone whose commercial, agricultural or industrial activities mandated
26 significant usage. From the vantage point of attempting to retain large energy users, our
27 problem was worse than the national numbers suggested. California was surrounded to the
28 north and east by states with electricity rates well below that average and each was
29 aggressively seeking to attract economic growth.

30 ...

1 **Q8. How did you and your colleagues on the California Commission respond?**

2 **A.** As President of the Commission I felt it our duty to understand the factors which had placed
3 us in this very non-competitive posture and to devise a strategy for controlling energy costs
4 in California. Our work took a little more than three years and is as remarkable for its
5 process as for the reforms which are taking life even as I write these words. In an effort to
6 assist the Arizona stakeholders and Commission, let me briefly chart the chronology of the
7 California effort.

8 ♦ **The “Yellow Paper” identifies a set of problems including a regulatory structure**
9 **increasingly focused on a mythical image of the electric services industry.**

10 My colleagues took on the task of responding to California’s non-competitive costs of
11 electric energy even as we were seeking to conclude a bitter trade dispute with Alberta over
12 the terms of natural gas purchases and deal with pressure to open our telecommunications
13 markets to full competition. In September, 1992, we directed the Commission Staff to
14 prepare a report that described current conditions and emerging trends facing the electric
15 industry. We also asked that both the substantive and procedural aspects of regulation be
16 examined to determine if they were part of the problem or a key to the solution. On February
17 3, 1993, the Commission released for public comment the resulting report entitled
18 *California’s Electric Services Industry: Perspectives on the Past, Strategies for the Future.*
19 Quickly branded the “Yellow Paper” because of the color of its cover, the report painted a
20 picture of an industry significantly evolved and differing from the one envisioned in our
21 regulatory efforts.

22 With the release of the Yellow Book the California Commission stood self-accused of
23 continuing to practice a form of command and control regulation over an industry structure
24 which had ceased to exist. We thought and acted as if California’s investor-owned utilities
25 were each a self-sufficient, self-contained vertically integrated monopoly secure within the
26 bounds of its state-conferred service territory. As captured in this vision, each utility
27 generated, transmitted and distributed electricity sufficient to meet the current and anticipated
28 needs of all users within the territorial confines of the monopoly. In 1992 that vision was a
29 myth. Owing to an aggressive implementation of PURPA by our predecessors, virtually all
30 new generation in California in the preceding decade had been built by non-utility vendors

1 with the electricity sold under long-term power purchase contracts to the state's investor-
2 owned utilities. Self-generation had become technologically feasible for many large users.
3 Transmission lines no longer exclusively served the transportation needs of the owner but
4 were under increasing pressure to facilitate energy transactions between non-adjacent
5 utilities.

6 Though not emphasized in the Yellow Paper, there was a companion defect to the
7 mythical focus of the Commission's regulatory efforts. We had forgotten the art of
8 rulemaking and settled instead into the clamorous comfort of regulation by adjudication. The
9 trial type hearing had become our single distorted window on the world. Former hearing
10 officers were transmuted into Administrative Law Judges. Time consuming proceedings
11 focused on the past shedding more heat than light on the problems of the industry.

12 ♦ **The "Blue Book" shocks the utility industry by using a broadly cast rulemaking**
13 **to discuss and debate a revised vision for the industry increasingly dependent**
14 **upon the discipline of competitive forces.**

15 After a little more than a year of monthly public hearings we issued an Order
16 Instituting Rulemaking and Order Instituting Investigation.⁴ Attached to that order as a
17 discussion vehicle, was a detailed description of an industry structure which embraced
18 competition in generation and the discipline of informed customer choice. Again, showing a
19 penchant for identifying Commission documents with the color of the cover stock assigned
20 by the state printer, this competition centered vision of the industry was popularly known as
21 the "Blue Book."⁵ I think that it is fair to assert that the Blue Book took the restructuring
22 discussion to previously unexplored dimensions both in terms of the numbers and scope of
23 participants as well as the detail in which issues were parsed. The vague phrase "retail
24 wheeling" receded before attempts to distinguish wholesale from retail competition and
25 grapple with the economics and physics of high voltage transmission. The ambitions as well
26 as fears of both incumbent utilities and prospective market entrants were reflected in a failure

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29 ⁴ R.94-04-031/I.04-04-032.

30 ⁵ For those of us destined to spend two discussing this industry model and debating its premises there is enduring
gratitude that the state printer did not elect puce cover stock.

1 to agree on the definition of these terms to say nothing of an industry structure. Our hearings
2 were held in large cities and modest towns from one end of the state to the other. Cable
3 television systems covered the discussions and video-taped copies were deposited in virtually
4 all public libraries. As public awareness of the debate began to grow, customers of various
5 classes started to organize, labor interests became engaged along with environmental
6 advocates and proponents of a variety of social welfare programs which, over time, had
7 become hallmarks of the known industry.

8 **Q9. How did you and your colleagues move this broadly cast dialogue to the point of**
9 **decision?**

10 **A.** We arrived at our declaration of policy positions, market design and transitional orders in two
11 stages. We issued a preliminary decision in May, 1995 and a final policy decision in
12 December of that year. The reason for this somewhat unusual approach can be traced in large
13 part to the Commission's interaction with the California Legislature. In the fall of 1994, the
14 public debate fostered by the Commission's release of the Blue Book began to reverberate
15 among members of the State Assembly and Senate. In response both houses passed
16 Assembly Concurrent Resolution 143 establishing a joint oversight committee and urging the
17 Commission not to make or seek to implement any final decision until it had addressed
18 nearly a dozen issues in a report to be submitted to both houses and the Governor.⁶ Among
19 the topics singled out in the resolution was a request that:

20 [The Commission Report] Quantifies and reports to the Legislature
21 and the Governor, after holding evidentiary hearings, both on the
22 competition transition surcharge for each utility and the allocation of
23 those charges among shareholders, classes of ratepayers, and direct
24 access and utility service customers.

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29 ⁶ The resolution was passed in both houses and filed with the Secretary of State on September 15, 1994. Given its
30 tenor as a "resolution," as opposed to legislation, it did not require presentation to the governor for concurrence or
veto and lacked the force of law. Notwithstanding, it was the unanimous view of the commissioners that we should
defer to its terms. Indeed, the opportunity to engage the active interest of the Legislature was most welcome.

1 Other provisions raised concerns over issues of reliability, environmental impacts, energy
2 conservation, and the consequences of any reform proposals on the fate of low income and other
3 assistance programs for the needy. The May decision which I am about to describe complied with
4 the letter and spirit of the legislative resolution.

5 ♦ **In May, 1995, the Commissioners divide 3-1 with the majority expressing a**
6 **policy preference for a pool-based market for competitive generation initially**
7 **limited to wholesale markets.**

8 After thirteen months of discussion and debate and with a service list grown to over
9 four hundred, the four sitting members of the Commission divided 3-1 on their design of a
10 replacement regulatory regime and industry vision.⁷ I wrote for the majority in expressing a
11 preference for an initial reform which concentrated on generation competition in the
12 wholesale markets. We called for the creation of a power pool which would make a
13 transparent market for generation and handle the operation of all high voltage transmission
14 assets to facilitate dispatch of the least costly set of generators capable of meeting
15 California's load at any given hour of the day. Issues of retail competition -- defined as
16 transactions between end users and generators, marketers or brokers -- were to be settled two
17 years after the pool had become operational. Transition costs were addressed by the majority
18 in the context of an initial reform of the wholesale market. The legitimacy of utility
19 aspirations that they be afforded an alternative opportunity to recover the yet-to-be realized
20 invested capital in assets that might prove unproductive, and held harmless against the terms
21 of power purchase contracts should they exceed the pool clearing price, were clearly
22 recognized.⁸

23 The terms of this decision were communicated to the Legislature and we immediately
24 began a series of what we term "full panel hearings" involving all sitting members of the
25

26 ⁷ *Re Proposed Policies governing Restructuring California's Electric Services Industry and Reforming Regulation*,
27 D.95-05-045, 60 CPUC2d 18, 157, 161 PUR4th 217 (1995).

28 ⁸ 60 CPUC2d at 176-182. In his statement of separate views, Commissioner Knight also addressed these issues
29 recognizing the intrinsic legitimacy of the utility ambitions but determined to minimize the costs and wary of a
30 collection methodology which might distort the competitive markets. His major point of departure from the
majority was on the role of the pool in serving as the market mechanism for competitive generation. In May, 1995,
Commissioner Knight was a proponent of what was termed "direct access" or "retail competition" under terms
which envisioned the relations between generators and end users as physical contracts to be literally accommodated.

1 Commission.⁹ All major features of both the majoring and dissenting opinion were slated for
2 hearings, any interested person or entity could provide written comments, and a combination
3 of invited witnesses and voluntary participants were engaged in the hearing dialogue. One of
4 those hearings focused on the topics of stranded costs, liabilities and benefits that were
5 anticipated in a competitive climate, and questions as to how a competition transition charge
6 should be formulated and levied.¹⁰

7 ♦ **December, 1995, the Commission divides 3-2 in reaching a final set of policy**
8 **preferences and industry framework. Transmission assets are placed under the**
9 **control of an Independent System Operator while the market for generation**
10 **embraces both a pool based Power Exchange and the availability of physical**
11 **bilateral contracts.**

12 In any debate framed by a polarization of opinion, the quest for a compromise or
13 middle ground is inevitable and marked the concluding chapter of the Commission's efforts.
14 In the wake of the Commission's divided May vote, many powerful interests, including a
15 large investor-owned utility, advocates of what was termed a "direct access" form of retail
16 competition, and certain environmentalists, sought to resolve their differences in a
17 Memorandum of Understanding.¹¹ A central feature of their recommendations was a
18 decoupling of the role of transmission operation and facilitation from the task of conducting
19 an auction market for least cost generation. In December the Commission, having been
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21 ⁹ The term "full panel" replaced "en banc hearings." As the Commission's presiding officer, I felt that we stood a
22 better chance of communicating with regulated entities and the People of California if the use of Latin was reduced
23 to de minimis proportions.

24 ¹⁰ The hearing was conducted in Pasadena, California, on August 21, 1995. Video and audio tapes of this and other
25 hearings were routinely made and broadcast over public access time on cable television systems, deposited in public
26 libraries, and made available to interested groups or individuals. Though I am not certain of their fate, I suspect that
27 should the Corporation Commission desire, a video transcript of this hearing and all documents filed by interested
28 parties providing written commentary on the many subjects could be obtained from the Executive Director of the
29 California Public Utilities Commission.

30 ¹¹ The major participants framing the Memorandum of Understanding included Southern California Edison, California
Large Energy Consumers Association, the California Manufacturers Association, and the Independent Energy
Producers Association. The Memorandum was published on September 11, 1995, and was addressed by the
Commission in a Full Panel Hearing held in Sacramento on September 13 and 14. On October 2, 1995, a second
joint recommendation, entitled the "Framework for Restructuring in the Public Interest" was presented by eleven
public interest, environmental, alternative energy and consumer advocacy organizations. Both the Memorandum
and the Framework contained discussion of stranded cost issues. Both documents are in the public domain and are
on file with the California Commission.

1 restored to its full strength by the appointment of Commissioner Neeper, issued its policy
2 decision and timetable for implementation.¹² While the members split on a 3-2 vote, it was
3 evident that the Commission was essentially united on the major outline of the industry
4 structure and corresponding regulatory reforms. The terms of the majority and dissenting
5 opinions spelled the end of the vertically integrated monopoly and the parsing of the industry
6 into distinct generation, transmission and distribution activities. Acceding to a central
7 suggestion from the Memorandum of Understanding, the majority opted for a Power
8 Exchange to provide all Californians with a transparent market for generation; consolidated
9 operational control over the transmission assets in California in an Independent System
10 Operator; made both the Exchange and the ISO FERC jurisdictional; opened the market to
11 retail competition with a variety of customer options; and redefined regulation of the
12 distribution function replacing cost-of-service concepts with performance based ratemaking.
13 Section V of both the majority and dissenting opinions addressed the issues of "Transition
14 Costs."

15 **Q10. Could you summarize the view of the majority and terms of the California**
16 **Commission's Policy Decision with respect to the fate of utility generating assets and**
17 **power purchase contracts which might prove uneconomic in the new, competition-**
18 **centered markets?**

19 **A.** Yes, beginning with the market model advanced in the Blue Book, and continuing in the
20 Proposed and Final Policy Decisions, the majority recognized the legitimacy of the claims
21 advanced in various forms by California's investor-owned utilities that restructuring was
22 fundamentally altering the terms of the social compact under which they had made capital
23 investments and incurred contract liabilities. Our response was to create an alternative to the
24 cost of service as a replacement opportunity for the utilities to recover those costs and a
25 declaration that utility shareholders would not be at risk for the consequences of honoring
26 outstanding power purchase contracts with non-utility generators.

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30 ¹² *Re Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation*, D.95-12-063, as modified by D.96-01-009, ___ CPUC2d ___, 166 PUR4th 1 (1996).

1 **Q11. You have indicated that the discussion model set forth in the Blue Book proposed to**
2 **recognize the legitimacy of what were termed transition costs, and that this was one of**
3 **the concerns articulated in the Legislature's Concurrent Resolution. Did the May**
4 **Proposed Policy Decision continue to reflect that position?**

5 **A.** Yes, in May, 1995, members of the public and the large list of stakeholders learned for the
6 first time the policy positions of individual Commissioners. Commissioners Conlon and
7 Duque joined me in forming the majority. Our view on the issues pending before the
8 Corporation Commission are best recounted by quoting from the opinion which we signed:

9 Our restructuring proposal moves from a regulatory structure in
10 which utility generation assets are a part of the integrated monopoly to
11 a pool structure in which many of these generation assets are
12 disaggregated from the utility and subject to the competitive
13 marketplace. In the new marketplace, some of these generation assets
14 will be competitive and some will not. Other current utility generation
15 assets are, as a group, more or less valuable now than after
16 restructuring.

17 This broaches the issue of transition costs. To the extent that
18 the set of utility assets are more or less valuable after restructuring of
19 the market than under today's regulatory regime, how should utility
20 shareholders or ratepayers be compensated for such changes in value
21 due to that transition? *Our philosophy is simple: We intend to honor*
22 *past commitments with as little disruption to the competitiveness of the*
23 *new market as possible, and consistent with avoidance of rate*
24 *increases to any customer class.*

25 ...

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1 To honor our past commitments, we will neither seek to
2 abrogate settlements related to nuclear power plants nor to disrupt
3 utility contracts with Qualifying Facilities . . .

4 . . .

5 In order to compensate shareholders for the transition costs
6 related to uneconomic assets, it is necessary to develop a method to
7 value the total uneconomic portion of these assets . . .¹³

8 We also recognized the legitimacy of including in recoverable transition costs regulatory
9 obligations directly related to generation as well as keeping faith with prior Commission
10 orders relating to accounting treatment of various utility accounts.

11 **Q12. Did the position of the dissenting Commissioner reject recognition that stranded costs**
12 **and liabilities be recovered from all ratepayers?**

13 **A.** No, Commissioner Knight, though differing from the majority in relation to the pool and in
14 his preference for the immediate implementation of direct, bilateral contracts, agreed that we
15 were obliged to recognize the basic legitimacy of the utilities' claims.¹⁴ His analysis divided
16 responsibility for generation investments that might prove uneconomic on a 10/90 basis
17 between the utilities and Commission yielding his suggestion that the utilities recover 90% of
18 their yet-to-be recouped investment in uneconomic generation units.¹⁵

19 **Q13. How were these subjects treated in your Commission's final Policy Decision?**

20 **A.** By the time we reached our final decision the positions of both the original majority and the
21 dissenter had been modified. In fact, they had come closer together on most of the
22 contentious issues. As I indicated earlier, the majority acceded to the suggestion of the MOU
23 parties that the task of making a transparent market for generation and the ongoing job of
24 providing transmission access should be separated and assigned to two distinct entities: the
25 Power Exchange and the Independent System Operator. Further, the majority yielded on the
26 initial preference that restructuring begin with a two-year period of generation competition

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¹³ 60 CPUC2d at 177.

29 ¹⁴ See discussion at 60 CPUC2d 92-104. His opinion is also useful for its review of the position of
30 many utility, non-utility, environmental and consumer stakeholders.

¹⁵ 60 CPUC2d at 96.

1 being confined to the wholesale market. It adopted the idea that generators should be able to
2 seek dispatch outside of the Power Exchange auction on the strength of bilateral contracts
3 with end users or through arrangements concluded by brokers or marketers. My colleagues
4 in the majority shared my view that bilateral contracts were, in the final analysis, financial
5 hedging arrangements and that so long as the Independent System Operator could assign
6 costs on the basis of neutral, non-discriminatory rates that fully captured all burdens imposed
7 on the system, the public was advantaged by allowing the greatest number of potential
8 consumer options.

9 As you might anticipate, the list of various costs, contract liabilities, social and
10 environmental programs likely to be impacted by a shift from cost-of-service regulation of
11 vertically integrated monopolies to a market for generation dominated by competition and the
12 disaggregation of traditional utility functions continued to dominate our debate. In this
13 context, we were now forced to provide detailed answers to the tough questions concerning
14 transition charges, their legitimate scope, method of calculation, identification of those who
15 would be liable for payment and the duration of the opportunity which should be given to the
16 utilities. Our ultimate disposition of these issues can best be explained by recurring to the
17 point I tried to make earlier: the recognition of stranded costs and liabilities and the quest to
18 place social and environmental benefits on a replacement financial footing were all elements
19 of what one commentator termed a "grand bargain." Indeed, as the Assigned Commissioner I
20 came to see the treatment of these issues as the key to providing both immediate and long-
21 term consumer benefits. Let me try to buttress these contentions as I recount the major
22 features of the majority's opinion and Commission Order.

23 **Q14. Please begin with the major issue before this Commission: On what basis did the**
24 **majority conclude that ratepayers should be responsible for the payment of transition**
25 **costs?**

26 **A.** In responding I must be careful to accurately portray the views shared by the three-member
27 majority from opinions and conclusions that I held individually at that time or which may
28 have subsequently been formed in my mind. The majority's rationale for accepting on behalf
29 of the ratepayers in the service territories of California's investor-owned utilities a liability to
30 afford those utilities an opportunity to recoup the yet-to-be recovered stranded generation

1 investments and to be held harmless against any over-market experience with existing power
2 purchase contracts was threefold.

3 1. *The majority refused to develop a case of selective amnesia respecting the*
4 *historic regulatory regime in which investments and contract liabilities which*
5 *may prove uneconomic in a reformed setting had been incurred.*

6 . . . As we move to rely on competitive markets to supply
7 power and to expand customer choices for power supplies, the
8 Commission must confront and dispose of those costs that both
9 keep rates high and act as an impediment to fair competition.
10 We have found that many of today's high costs result from past
11 regulatory promises made by the Commission regarding the
12 timing of the recovery of depreciation and taxes, past
13 requirements to diversify sources of power by signing long-
14 term contracts that in hindsight have high costs, and the costs
15 incurred by utilities (most notably those associated with QFs
16 and nuclear power) that were reviewed and deemed reasonable
17 when incurred.¹⁶

18 2. *The majority espoused a goal assuring the continued financial integrity of*
19 *California's investor-owned utilities.*

20 To assure the continued financial integrity of the
21 utilities, and give them an opportunity to be vital
22 market participants in the restructured market following
23 the transition, we will allow them to recover completely
24 costs associated with contracts for power and prior
25 regulatory commitments, called regulatory assets. We
26 will continue to honor regulatory commitments
27 regarding the recovery of nuclear power costs. For
28 other generating plants, we commit to an accelerated
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¹⁶ 166 PUR4th 1, at 45.

1 recovery of the net book value of those undepreciated
2 assets and other fixed obligations combined with a
3 reduction in the return on those assets which make
4 claims for transitional support.¹⁷

5 3. *In the eyes of the majority, to fail to impose a competition transition charge*
6 *would be to radically shift liabilities and risks previously assigned to*
7 *ratepayers to utility shareholders at the very point in which the monopoly*
8 *concession was being overturned.*

9 . . . We note for clarity that future potential transition
10 costs (with few exceptions) are already embedded in
11 utility rates today; transition costs would simply be
12 identified in a different way than they are today and this
13 change should neither create a new ratepayer cost nor
14 result in a higher revenue requirement.¹⁸

15 In light of these beliefs and view of the facts, the majority concluded:

16 . . . that the utilities should be allowed to recover appropriate transition
17 costs. Longstanding regulatory policies, past Commission decisions, and
18 ongoing regulatory effects persuade us of the need, during the transition to
19 full competition, for a process to account for the lingering effects of
20 today's market structure. Thus, we must develop a method to minimize
21 the effects of the high-cost elements in the competitive market structure,
22 while we close the books on past practices. We will identify utility
23 capital investments and contractual obligations, quantify their costs as
24 accurately as possible, and separately identify a charge to recover these
25 costs. Our goal is to get through this transition period as quickly as
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30 ¹⁷ 166 PUR4th at 45-46.

¹⁸ 166 PUR4th at 46 (emphasis added).

1 possible so that full competition can begin with minimal market
2 distortions.¹⁹

3 **Q15. Given that set of beliefs, did the majority feel that all burdens associated with**
4 **uneconomic utility investments should be born by ratepayers leaving utility**
5 **shareholders exempt from any financial consequences?**

6 **A.** No, and it is very important that the Corporation Commission understand this point. The
7 California position on stranded costs (as distinguished from stranded liabilities for over-
8 market power purchase contracts or the recovery of regulatory assets) was that utility
9 shareholders were to bear their fair share of the financial burden and risks associated with the
10 introduction of new markets which offered opportunities to utility management even as it
11 repealed the vertically integrated monopoly status. For present purposes, the most significant
12 financial consequences to shareholders were:

- 13 (1) the loss of the historic imputed cost of capital on generation assets making claims to
14 transitional support;
- 15 (2) the Commission-imposed cap on utility revenues during the transition period; and
- 16 (3) the Commission-imposed time frame or deadlines on the opportunity to calculate and
17 recover stranded costs.

18 **Q16. Explain the reform in the treatment of the capital structure attributed to utility**
19 **generation assets.**

20 **A.** Historically, California's investor-owned utilities have been allowed to earn a Commission
21 set return on all prudent investments. The annual cost of capital proceeding addressed a
22 fundamental feature of the utilities' capital structure: funds which represented shareholder
23 investment (equity) and those which reflected shareholder obligations on borrowed capital
24

25 ¹⁹ 166 PUR4th at 48. These views were shared by Commissioners Knight and Neepser. Gone was Commissioner
26 Knight's original preference for a 10/90 split. Instead the dissenters declared:

27 We have always agreed that some portion of the utility will continue in the future to provide
28 what we consider 'monopoly' service. Moreover, we recognize that today's monopoly
29 provider made certain investments for which the current regulatory system offers a reasonable
30 opportunity of recovery. Thus, we agree that California's investor-owned utilities should be
allowed the opportunity to recover so-called "stranded costs" in the future, although at a
reduced rate of return to reflect the appropriate risk profile for this recovery . . .

166 PUR4th at 104.

1 (debt). Differing levels of returns were fixed on the equity and debt components, the first
2 being treated as an at-risk investment while borrowed capital was deemed a cost of doing
3 business. The recognition of the risk factor on the equity investment traditionally led to a
4 higher allowed return. In a significant innovation, the majority abolished the shareholders
5 right to earn a return on this equity investment (the first shareholder sacrifice) and elected to
6 treat the equity portion of funds yet to be recouped for generation assets as a specie of
7 imputed debt. A second shareholder sacrifice was then imposed. Under the terms of the
8 order, on a going forward basis, the return on the percentage of the undepreciated asset
9 financed by equity was fixed at a level 10% below the long-term cost of debt.²⁰

10 When it is remembered that the historic capital structure of California's investor
11 owned utilities is about 50/50 debt and equity, the consequences of transforming higher
12 return equity components into imputed debt and then fixing the return at a rate 10% below
13 that allowed on long-term debt can be appreciated.

14 **Q17. You have mentioned a Commission imposed cap on utility revenues, did that shift**
15 **significant risk respecting the potential collection of stranded assets to the utility**
16 **shareholders?**

17 **A.** Yes, the majority recognized that a major goal of the restructuring effort was to lower the
18 price consumers paid for electricity. Imposing a competition transition charge contravened
19 that goal with the further risk to consumers that the market determined price for generation
20 could rise as well as fall in an unfolding future. To partially offset this risk the majority
21 imposed a cap on utility revenues so that the price for electricity on a kWh basis cannot rise
22 above the levels in effect on January 1, 1996 without adjustment for inflation. This means
23 that no matter the calculation method, for the life of the transition period the utility must
24 manage and mitigate its costs because the shareholders are at the peril of any excess over the
25 capped revenues.

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28 ²⁰ The majority opinion provided for a potential easing of this 10% reduction if the utility divested generation assets
29 eligible for CTC recovery. Given a concern for the potential market power represented by the generation holdings
30 of Pacific Gas & Electric and Southern California Edison, the utilities could earn a 10-basis point increase in the
imputed debt portion of their capital structure for each 10% of fossil plants divested by sale or spin-off to an
unaffiliated entity.

1 **Q18. You just mentioned the “life of the transition period.” Under the California**
2 **restructuring is there a limitation on the time frame over which stranded costs are to be**
3 **calculated and recovered?**

4 **A.** Yes, under terms of the Final Order, a transition cost balancing account was established for
5 each investor-owned utility. The process of valuing assets for inclusion in that account began
6 in 1996 and is to be completed by the end of 2003. After 2003 no further accumulation of
7 transition costs will be allowed unless derived from existing power purchase contracts and
8 related to ongoing contractual payments that continue beyond that date. With the exception
9 of honoring the terms of utility obligations under power purchase contracts formed before
10 December, 1995, the opportunity to complete the collection of transition costs for generation
11 assets, retraining and early retirement of affected utility employees, and regulatory assets
12 must be completed by the end of 2005.

13 **Q19. Given the interest in calculation methods expressed in the Corporation Commission’s**
14 **Procedural Order, would you briefly describe the calculation methodology adopted in**
15 **California for determining the stranded cost eligibility for utility generation assets?**

16 **A.** A review of our work product starting with the *Blue Book* and concluding with the *Final*
17 *Order* reveals a significant evolution of attitudes on this issue. This subject is again, at once
18 conceptually simple and practically difficult. In simple terms, a utility asset is uneconomic if
19 its net book value exceeds its market value, and an asset is economic if its market value
20 exceeds its net book value. Thus, for any particular utility, its transition costs are the net
21 above-market costs associated with all of its generation assets, both economic and
22 uneconomic. But how does one fix the market value of a given asset? There are two rival
23 approaches: an administrative vs. a market based methodology. We began the first and
24 wound up with the second.

25 **Q20. Before you describe your reasons for shifting from an administrative to a market-based**
26 **calculation methodology, please focus on the California Commission’s determination to**
27 **arrive at a net above-market asset calculation.**

28 **A.** We adopted this view without serious opposition for it is a matter of fundamental fairness.
29 Under the existing regulatory structure, ratepayers have a claim to the power produced by all
30 of the utility’s generating units even those which were fully depreciated. The assets had been

1 dedicated to public use as part of the regulatory compact. In the new regulatory structure,
2 once a plant had been reduced to a market valuation it will lose its dedicated status if it is
3 sold to a new owner. To compensate ratepayers for this loss of continued dedication we
4 determined to net out those economic or productive units against the units that proved to be
5 uneconomic. Only if there is a net negative number does the utility become entitled to avail
6 itself of the opportunity to collect transition costs.²¹

7 **Q21. Why did the California Commission abandon the administrative approach to**
8 **calculating stranded costs?**

9 A. Because we could not make it work. The Blue Book clearly envisioned an *administrative*
10 *approach* in which the Commission would employ the hearing process to forecast the
11 stranded cost calculation. Responding to the Legislature's request in the concurrent
12 resolution, we attempted such a proceeding. The hearing before an administrative law judge
13 quickly found a total absence of agreement among the various stakeholders as to the variables
14 that were to be included in the forecast. Even when they could agree on a variable such as a
15 long-term forecast of market prices and assumptions about QF obligations, discount rates,
16 capacity factors, and the like they could not agree on the methodology. In the end the ALJ
17 reported to us that the figure fell within a range of a negative \$8 billion to a utility claim on
18 ratepayers in excess of \$32 billion. Thirty years ago I argued before the United States Court
19 of Appeals for the Fifth Circuit in a proceeding presided over by Chief Judge Brown. I
20 remember his ringing aphorism, "figures speak and when they do courts listen." In 1994 as
21 the President of the California Commission I concluded that figures speaking over a range of
22 \$40 billion offered no guidance to me or my colleagues. We abandoned the administrative
23 approach.

24 **Q22. Explain the market-based calculation methodology embodied in the Final Order.**

25 A. As reflected in our May, 1995 Proposed Policy Decision and particularized in the December
26 Final Order, we shifted to a *market based* approach in which the calculation would be made
27 by observing the performance of utility generation assets in the Power Exchange or in sales
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²¹ 166 PUR4th at 48-49.

1 or spin-offs to new owners. Because we are unable to predict the specific fate of various
2 generation assets, the Order envisions three alternative ways to calculate transition costs.

3 The first approach is to calculate transition costs on an ongoing basis by comparing
4 the authorized revenues associated with the plant to the actual revenues earned through sales
5 into the Power Exchange. This will be the fate of utility generation that remains under utility
6 ownership but exhibits a history of success in gaining dispatch through the Exchange.

7 The second approach will be used if the utility chooses to sell the generating asset to a
8 third party or spin it off to an unaffiliated corporate entity. We will use this transaction to
9 establish the market value of the unit and calculate any transition costs by deducting the sales
10 price or stock market value of shares issued to effect the spinoff from the asset's net book
11 value. I can report to the Corporation Commission that news accounts reveal that both
12 Southern California Edison and Pacific Gas and Electric have aggressively pursued this
13 alternative and sold off fossil assets at prices which exceed book values. The proceeds of
14 these sales are recorded in the utilities' stranded costs accounts and will reduce any other
15 claims to transition costs. This development is doubly encouraging for it has reduced the
16 anticipated stranded costs (contrary to the near universal projections in the 1994
17 administrative proceeding) and reduced market power concerns with the integrity of the
18 Power Exchange.

19 The third approach would rely on appraisal valuation using independent industry
20 experts. As envisioned in the Order, this approach would be used if the utility elected to
21 retain ownership or used some form of accounting separation. I readily admit to some
22 confusion as to the anticipated circumstances in which this approach would supplant the first
23 alternative of tracking the income received from Power Exchange dispatch and determining if
24 it would produce a shortfall in recovering the utility's remaining invested capital.

25 **Q23. So it would be fair to characterize the California Commission's Final Policy Order as**
26 **affording the affected utilities an opportunity to recover the stranded costs associated**
27 **with uneconomic generation assets but it does not *guarantee their ability to do so?***

28 **A.** That is correct, and our rationale for taking this position is founded on our understanding the
29 classical command and control regulation under which these investments were made. Our
30 obligation under the regulatory compact with investor-owned utilities was not to guarantee

1 utility earnings on a ratebase deemed reasonable and prudent but to provide an *opportunity*
2 for the utilities to earn a fair return on that investment. This was and remains our reading of
3 the state's obligation under *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1988). As we
4 move from that classical regulatory model into one which fundamentally alters the contours
5 of the state recognized monopolies and introduces competition, California continues to have
6 the obligation to design and administer a structure the total impact of which provides the
7 utilities with that opportunity. Taken in the context of our policy objectives and the new
8 opportunities which are created by the new market structure for both classical participants
9 and new market entrants, it is our belief that allowing the utilities the time limited
10 opportunity to recover generation plant-based transition costs and providing an appropriate
11 risk-based rate of return until those costs are recovered meets that obligation.²²

12 **Q24. You have indicated the time frame for calculating stranded costs and the deadline on**
13 **collection efforts. Under the California Order who is liable for the payment of the**
14 **competition transition charge?**

15 **A.** The Final Order authorizes recovery through a non-bypassable end-user surcharge imposed
16 on all users who were retail customers of an investor-owned utility on or after December 20,
17 1995 whether they continue to take bundled service from their current utility or pursue other
18 options.

19 **Q25. At an earlier point you indicated that in arriving at its position on stranded costs the**
20 **California Commission was able to tie this aspect of the restructuring to the delivery of**
21 **immediate and mid-term benefits to consumers. How was this accomplished?**

22 **A.** The Final Order provides that, so long as the utilities are seeking recovery of stranded costs,
23 they must sell all of their generation into the Power Exchange and make proxy purchases of
24 electric energy on behalf of any customer who elects to delegate that function to them from
25 the Power Exchange. I predict that early in this year when the Power Exchange and ISO
26 become operational, the overwhelming majority of California's users of electricity had not
27 elected an alternate energy provider and were thus continuing to use their historic utility to
28 procure electric energy on their behalf. Assuming that the Power Exchange functions as a
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30 ²² 166 PUR4th 46, 49-50.

1 transparent market capable of seeking dispatch of the lowest cost set of generators capable of
2 meeting California's energy needs at any hour, and that there are additional savings as a
3 result of the Independent System Operators control of the transmission assets, the issue
4 which faced us is how do you ensure that all users benefit from these savings? Our answer
5 was that so long as they were being surcharged for the competition transition charge, the
6 electric utilities were obliged to bill their customers for their usage of electric energy as the
7 cost of procurement in the Power Exchange without an iota of markup.²³ Thus, under the
8 California Plan the phrase, "I can get it for you wholesale" is not a seller's con. It is a
9 buyer's right.

10 **Q26. Could you address the changes in the Commission's Final Order made by the**
11 **subsequent passage of restructuring legislation in California. The Commission would**
12 **be particularly interested in knowing if any of the stranded cost calculation, recovery**
13 **periods or other features to which you have testified were changed.**

14 **A.** In September 1996 the Legislature passed and Governor Wilson signed comprehensive
15 electric restructuring legislation, Assembly Bill (AB) 1890 (Stats. 1996, Ch. 854), which
16 affirmed all of the California Commission's policy decisions enunciated in its final order.
17 AB 1890 modified some of the implementation details affecting stranded costs. Most
18 noteworthy was the legislation's call for securitizing a portion of the utilities' stranded
19 costs.²⁴ Given its implication of other California agencies, including the California
20 Infrastructure and Economic Development Bank, this was an action that was beyond the
21 California Commission's jurisdictional ability and could only have been effectuated by the
22 California Legislature. Securitizing a portion of the utilities' stranded costs was completed at
23 the end of last year when both Pacific Gas and Electric and Southern California Edison
24 successfully marketed multi-billion dollar issues of transition bonds that were issued at an
25

26 ²³ The Corporation Commission may be interested to know that as a matter of right all California customers may elect
27 to be billed for the energy component of the utility bills in a computation using the average price in the Power
28 Exchange over the billing period or, if they obtain a meter, the price from the Power Exchange computed in real
29 time according to their usage. It is my hope that many Californians will elect to respond to the price signals sent
30 from the Exchange to shift their usage patterns from peak and thus costly periods and to begin to fill in the valleys
in the state's demand curve. If this is accomplished, individual consumers will see lower bills and the entire
infrastructure will be used far more efficiently.

²⁴ Sections 840-47 of the California Public Utilities Code.

1 average interest rate below 6.5%, earned a AAA rating and were eagerly acquired by an
2 enthusiastic capital market. The reduced interest cost and longer amortization period²⁵
3 allowed the utilities to meet the mandate of AB 1890 that all residential and small
4 commercial customers receive a 10% rate reduction effective January 1, 1998.²⁶

5 AB 1890 departed from the California Commission's final policy decision on
6 stranded cost in two other matters. First, while the California Commission had set the
7 stranded cost recovery period to run through the year 2003, AB 1890 shortened the recovery
8 period to December 31, 2001 for stranded generation costs and extended the period for
9 recovery of employee-related transition costs to December 31, 2006.²⁷ AB 1890 did not
10 modify the California Commission's treatment of power purchase contract obligations,
11 finding it in the public interest that these obligations will continue for the duration of the
12 contracts. Similarly, AB 1890 left in place the California Commission's April 1996 decision
13 on the transition cost plan for the San Onofre Nuclear Generating Station which calls for
14 recovery to extend not beyond December 31, 2003.²⁸

15 Second, the California Commission had mandated that stranded costs be paid by all
16 retail customers. AB 1890 carved out some limited exemptions for stranded cost
17 responsibility for various irrigation districts, water districts, and water agencies.²⁹ The costs
18 associated with these exemptions could be collected from all remaining customers, except
19 residential and small commercial customers, for an additional three-month period from
20 December 31, 2001 through March 31, 2002, provided that only \$50 million of the balance of
21 the costs remaining after December 31, 2001 will be eligible for recovery.

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28 ²⁵ The rate reduction bonds are repaid over a period of ten years as opposed to the five-year CTC recovery period.

29 ²⁶ Section 330(w) of the California Public Utilities Code.

30 ²⁷ Section 367 of the California Public Utilities Code.

²⁸ D.96-01-011 and 96-04-059.

²⁹ Section 374 of the California Public Utilities Code.

1 27. Would you please summarize the decisions issued by the California Commission to
2 implement the stranded cost directives of the California electric restructuring
3 legislation?

4 A. In the last half of 1997, the California Commission implemented many of the stranded cost
5 directives contained in AB 1890. In a June, 1997 decision, the Commission determined that
6 the stranded cost portion of a customer's bill, the so-called competitive transition charge
7 (CTC), will be computed as the difference between the total rate and all other charges,
8 including the Power Exchange price, thereby ensuring that the allocation of the CTC does not
9 result in rates above the June 10, 1996 levels.³⁰ In that same decision the Commission
10 confirmed that customers will be responsible for paying the CTC regardless of whether they
11 buy electricity from the utility or from alternative suppliers. The Commission held that the
12 utilities must amortize assets with a higher rate of return prior to assets with a lower rate of
13 return.

14 The June decision also held that utilities can defer recovery of several categories of
15 transition costs mandated by AB 1890 past 2001 if the current recovery of these costs would
16 impair the utilities' ability to recover generation-related CTC costs.³¹ All other transition
17 costs must be recovered by December 31, 2001. Employee-related transition costs can be
18 collected through 2006. Restructuring implementation costs, including the costs of
19 developing the Power Exchange and the Independent System Operator, which the investor-
20 owned utilities have funded to date, may be collected until fully recovered. The cost of AB
21 1890 mandated renewables programs may be collected until March 31, 2002. Transition
22 costs related to power purchase contracts and QF contracts may be collected for the duration
23 of the contract.

24 In a November, 1997 decision, the Commission established the eligibility of various
25 categories of non-nuclear costs for transition cost recovery and quantified the net book value
26 of assets of PG&E, Edison, and SDG&E. The net book value of the assets establishes the
27 baseline against which market valuation will later be measured. The decision establishes that
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29
30 ³⁰ D.97-06-060.

³¹ D.97-11-074.

1 costs eligible for recovery can only be determined based on marketplace valuations, rather
2 than administrative forecasts, and that future operational costs, dubbed "going-forward
3 costs," must be recovered through market prices, not the CTC.

4 **Q28. Do you have any concluding comment on the California regulatory and legislative
5 approach to restructuring?**

6 **A.** Yes. As each of the Corporation Commissioners is keenly aware, restructuring touches many
7 interests and a very wide array of stakeholders. Both the Final Order and AB 1890 represent
8 efforts to balance these interests in a manner that produced terms that were framed in the
9 public interest and which doubtlessly disappointed the specific ambitions of virtually every
10 participant. This is in the nature of our political process taken in its most positive light. My
11 fear is that students of what was done or not done in California will attempt to pick and
12 choose elements of that reform without realizing that it constitutes an attempt at a balance.
13 This is particularly true of the policies and implementation strategies on the utility
14 investment, power purchase contracts and social and environmental programs likely to be
15 impacted by the move toward markets.

16 **PART TWO: BOTH THE EXISTING AND ANY REFORMED RELATIONSHIP**
17 **BETWEEN THE STATE OF ARIZONA AND THE AFFECTED UTILITIES**
18 **REFLECT A SOCIAL CONTRACT**

19 **Q29. Are you familiar with the argument that in our market-based economy business entities
20 must bear the burdens of imprudent or unwise business decisions and cannot expect to
21 pass any loss onto their customer base?**

22 **A.** Yes, and as it pertains to individuals or entities which have freedom to enter and exit markets
23 and product lines, to pick and chose among their potential customers, and to set any price that
24 the market will bear, I am in full agreement with this position.

25 **Q30. Given your agreement with this basic proposition, is it your opinion that the "Recovery
26 of Stranded Cost of Affected Utilities" provisions should be modified so as to preclude
27 utility claims to stranded costs?**

28 **A.** No, in fact I agree with the general tenor of A.C.C. R14-2-1607 and its recognition that,
29 subject to a duty on the part of the utilities to take active steps to mitigate the magnitude of
30 their stranded costs, it is fully appropriate that existing ratepayers on whose behalf the assets

1 were constructed and liabilities assumed should bear those costs. I support the principal that
2 net uneconomic generation assets, above-market power purchase contract obligations and
3 regulatory assets remain the obligation of ratepayers and that restructuring not be used as an
4 opportunity to attempt to shift them to utility shareholders. I have reached this conclusion
5 after considering the legal and moral obligations owed to what are, in Arizona, deemed
6 public service corporations. As an individual who believes in the reform of the electric
7 service industry and the discipline of competition and customer choice, I favor the
8 recognition, calculation and collection of stranded costs for pragmatic reasons that are rooted
9 in the future not the just demands of the past. Until this matter has been resolved in a
10 principled and sustainable manner, the Corporation Commission will not have the active
11 cooperation of the affected utilities. A denial of the basic claim to stranded costs will
12 doubtlessly occasion litigation and the expense in both time and treasure that would be
13 consumed will frustrate the onset of competition and distort the emerging markets. None of
14 these avoidable consequences is in the public interest.

15 **Q31. You indicate that “legal and moral” reasons have made you an advocate of stranded**
16 **cost recovery by investor-owned utilities. Is this the “social or regulatory contract”**
17 **argument?**

18 **A.** Yes, and you will note that the premises of the argument were not overtly discussed in my
19 analysis of the California Restructuring or contained in the quoted excerpts from the
20 Proposed and Final Policy Decisions. This is because in California the social contract can be
21 found in the literal terms of the state constitution, a comprehensive set of statutes termed the
22 Public Utilities Code, and hundreds of bound volumes of decisions and orders of the
23 Commission. It is this historic and ongoing state presence which distinguishes what we
24 commonly refer to as “utility services” from all other forms of enterprise and subject them to
25 active state regulation. This regulation arises in many forms and manifests itself in
26 legislation as well as the constitutional provisions setting up the Public Utilities Commission.
27 Taken as a whole, the provision of electricity in California is regulated in terms of safety,
28 reliability and environmental consequences. Entities deemed to be public utilities enjoy none
29 of the freedom which I ascribed to the private individual or entity to enter and exit markets

30 ...

1 and product lines, to pick and chose among their potential customers, and to set any price that
2 the market will bear.

3 It is equally undeniable as to the identity of the individuals on whose behalf the
4 constitutional, legislative and regulatory mandates have been imposed on public utilities. All
5 individuals who reside within the service territory of a public utility are entitled to service on
6 an equal, adequate and non-discriminatory basis. They are historically termed "ratepayers"
7 for the simple reason that they could not be assessed any charge or fee for energy services
8 that was not first approved by the state and found to be just and reasonable.

9 **Q32. The social contract and duty to serve which you found in California may justify, if not**
10 **require, the recognition of stranded cost recovery in your State, but do they have any**
11 **bearing on Arizona and the Corporation Commission?**

12 **A.** Yes, a study of Arizona authorities reveals that the social contract and duty to serve have all
13 of the roots found in California plus an additional and wholly independent basis in Arizona
14 law. Article 15 of the Constitution of the State of Arizona not only constitutes and empowers
15 the Corporation Commission, but it declares the will of the People of Arizona to deem all
16 corporations, other than municipal entities, engaged in furnishing electricity for light, fuel or
17 power "public service corporations."³² The authority over the terms and conditions of service
18 by such entities and the commands of the State are forcefully advanced in Section 12:

19 All charges made for service rendered, or to be rendered, by public
20 service corporations within this State shall be just and reasonable, and
21 no discrimination in charges, service, or facilities shall be made
22 between persons or places for rendering a like and contemporaneous
23 service . . .³³

24 I find ample evidence that the Arizona Legislature has been as vigilant and active as
25 its California counterparts in enacting comprehensive legislation to direct the Commission
26 and address issues of reliability, safety, environmental and economic regulation. As the
27 primary active agent articulating and defending the public interest, this Commission's record
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29
30 ³² A.R.S. Const. Art. 15, § 2.

³³ A.R.S. Const. Art. 15, § 12.

1 is written in an enviable history and continues right up to the current proceeding. An
2 individual seeking to deny the existence of an overt social contract between the people of
3 Arizona, acting through their government, and the public service entities engaged in the
4 provision of electricity in this State would be forced to ignore the constitution and statutes
5 and at a loss to explain the very venue and occasion for this hearing.

6 **Q33. Please identify what you have characterized as Arizona's additional and wholly**
7 **independent basis for the social contract and the duty to serve.**

8 **A.** I am referring to the Supreme Court of Arizona's 1948 adoption of a common law basis for
9 regulating the service obligations of electric utilities and obligating them to serve all potential
10 users within the confines of their service territory on an equal, adequate and non-
11 discriminatory basis. The landmark decision was rendered in *Town of Wickenburg v. Sabin*,
12 68 Ariz. 75, 200 P.2d 342. It is remarkable because the defendant was a municipality which
13 had elected to commence the provision of electricity and water to its residents. Sabin, a
14 resident of Wickenburg, made application for both services offering payment of \$5.00 for
15 each. His application was denied on the grounds that he was seeking service to a temporary
16 structure. Sabin was informed that unless he was prepared to pay \$50.00 and guarantee the
17 building of a permanent residence on the lot, he would not be served. Sabin claimed
18 discrimination asserting that no other resident had been subjected to such conditions. He
19 brought suit before the Superior Court of Maricopa County seeking a writ of mandamus
20 compelling the municipality to extend service to his home. The trial court granted the writ
21 and the town appealed to the Supreme Court.

22 Justice Udall authored the unanimous opinion affirming the trial court and ordering
23 that Sabin receive electric and water service. The court did not rest its decision on
24 constitutional or statutory grounds, but upon its embrace of the common law duty to serve.
25 Quoting from and adopting for Arizona a formulation given in *MCQUILLIN ON MUNICIPAL*
26 *CORPORATIONS*, the court observed:

27 . . . A public service corporation is impressed with the obligation of
28 furnishing its service to each patron at the same price it makes to every
29 other patron for the same or substantially the same or similar service.
30 'It must be equal in its dealings with all.' . . . 'All should be treated

1 alike, equality of rights requires equality of service.' 'The duty owed
2 to all alike involves obligations to treat all alike.' The common law
3 upon the subject is founded in a public calling to charge a reasonable
4 and uniform price to all persons for the same service rendered under
5 the same circumstances.³⁴

6 At a later point the Court responded to the town's argument that it wished to retain
7 discretion respecting extensions of its service obligations:

8 . . . there is respectable authority to the effect that a municipality, as
9 distinguished from a private utility corporation, may exercise
10 governmental discretion as to the limits to which it is advisable to
11 extend its water mains and power lines . . .³⁵

12 It would be difficult to formulate a more sweeping adoption of the duty to serve. It
13 bears repeating that the court deemed it to fall with greater rigor on a private utility than its
14 municipal counterpart. With respect to private utilities no discretion was conceded regarding
15 service to new customers. *Wickenburg* is consistently cited by both the Arizona Supreme
16 Court and Court of Appeals for the assertion and definition of the duty to serve. It is deemed
17 relevant to the functions of both municipal and investor-owned utilities in this State. See,
18 *Veach v. City of Phoenix*, 102 Ariz. 195, 427 P.2d 335 (1967); *General Cable Corp. v.*
19 *Citizens Utilities Company*, 27 Ariz. App. 381, 555 P.2d 350 (1976); and, *Marco Crane and*
20 *Rigging v. Arizona Corporation Commission*, 155 Ariz. 292, 746 P.2d 33 (Ariz. App. 1987).

21 **Q34. It is your contention that decisions of affected utilities to invest in generating assets,**
22 **enter power and fuel purchase contracts, and accept the Commission's terms and**
23 **conditions with respect to regulatory assets sets a stage which is fundamentally unlike**
24 **the decisions of unregulated business entities?**

25 **A.** Yes. Such decisions were made under an overt constitutional, statutory, common law and
26 administrative mandate on behalf of all ratepayers. If today technology and revised attitudes
27 toward the appropriate sweep of monopolies cause us to rethink regulation, I respectfully
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30 ³⁴ 68 Ariz. at 77-78, 200 P.2d at 343-344.

³⁵ 68 Ariz. at 79, 200 P.2d at 345.

1 suggest that we must do so with an intention to honor the terms of the regulatory compact.
2 Utilities did not enjoy a guarantee that just and reasonable rates would fully compensate them
3 for such risks and investments, but they were assured a fair opportunity to accomplish that
4 vital objective. During my privileged time as a public servant in California, I viewed the
5 *Duquesne* decision of the United States Supreme Court as obliging us to provide a
6 replacement "fair opportunity" as we pursued the public advantage in a restructured
7 environment.³⁶ I thought it was my legal obligation and, equally important, my moral duty as
8 an agent of the People of California. The alternative would have been years of litigation.

9 **PART THREE: THE COMMISSION'S SPECIFIC QUESTIONS**

10 **Q35. Your testimony respecting the terms of the California Restructuring addresses all but**
11 **the accounting questions posed in the Procedural and First Amended Procedural**
12 **Orders. How do you propose to comment further on those matters?**

13 A. With respect, I have no views that are of use to the Commission on the question in the
14 Amended Procedural Order relating to the implications of the Statement of Financial
15 Accounting Standards No. 71. Nothing in my background as a school teacher, regulator or
16 lawyer sheds even candle light on these critical matters. Also, with the Commission's
17 permission, I will not comment on Issue 2. In my view, when the affected utilities should be
18 required to make a stranded cost filing is peculiarly a matter for this Commission to decide,
19 although the time frame outlined in Mr. Bayless' testimony seems reasonable.

20 I also appreciate that the Corporation Commission's December, 1996, Retail Electric
21 Competition Rules reflect an Arizona approach to restructuring which may, or may not,
22 mirror concepts of the public interest as they were framed in California. That is as it should
23 be. We do seem to be on common ground in the desire to re-evaluate the terms of classical
24 regulation to see if they continue to maximize the public advantage from the electric service
25 industries in our respective states. There is also common desire to explore competition in
26 generation and to look closely at other aspects of the traditional vertically integrated
27 monopoly model to determine if competition and unbundling can produce greater
28 efficiencies.

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³⁶ *Duquesne Light Co. v. Barasch*, 488 U.S. 299 (1988).

1 Most importantly, from the vantage point of today's hearing, the Commission's Rules
2 address the recovery of stranded costs of affected utilities.³⁷ The eleven issues which the
3 Commission posed for consideration by the Working Group reveal a grasp of virtually every
4 complexity identified in my experience in California. But in the movement since the
5 issuance of the Article 16 Retail Electric Competition Rules, it is my perception that Arizona
6 is diverging on a fundamental tenant of the restructuring debate. While R14-2-1610 declares
7 that "[t]he Commission shall conduct an inquiry into spot market development and
8 independent system operation for the transmission system" and "may support development of
9 a spot market or independent system operator(s)," my reading of the Report submitted by the
10 Stranded Cost Working Group leaves me with the impression that competition will begin on
11 a date certain in Arizona in a landscape which will feature neither entity. If such is, in fact,
12 the route taken by restructuring in Arizona, then while the California experience may have
13 some relevance in indicating implementation strategies to pursue or avoid, it must be
14 distinguished on aspects of the questions set forth for this hearing.

15 **Q36. You indicate that the absence of a market mechanism comparable to the Power**
16 **Exchange and Independent System Operator will reduce the relevance of many of the**
17 **California implementation strategies to the Arizona restructuring. Why is that so?**

18 **A.** Because the Power Exchange is the key in the California plan for getting our arms around the
19 critical factual inquiry upon which stranded cost recovery can be approached: what is the
20 clearing price for generation in the reformed market? In my response to Question 21, I
21 indicated that our attempt to utilize an administrative approach to project a future market and
22 market price was totally unsuccessful. Over time, that lack of success pushed us toward the
23 belief that having a transparent spot market which would handle all of the sales from utility-
24 owned generation during the transition period, and from which the distribution utilities would
25 make their purchases on behalf of full service customers, would enable us to supplant
26 guesswork with facts. As I reflect on this decision, I am forced to conclude that the
27 California experience with Standard Offer Contracts and the fate of our attempts to project
28 fuel costs may have hobbled our faith in our powers of estimation.

30 ³⁷ A.A.C. R14-2-1607

1 Notwithstanding this fundamental distinction, my study of the Competition Rules and
2 the Report submitted by the Stranded Cost Working Group is the background for some
3 comments I would like to share with members of the Commission addressing questions in the
4 Procedural Orders.

5 **ISSUE 1. SHOULD THE ELECTRIC COMPETITION RULES BE MODIFIED REGARDING STRANDED**
6 **COSTS. IF SO, HOW?**

7 **Q37. Do you have any specific recommendations for modifications to R14-2-1607?**

8 A. Yes, as I read R14-2-1606 on the Services Required To Be Made Available by Affected
9 Utilities, and R14-2-1607, I believe that the Commission is proposing in Sub-section J that
10 customers taking the Standard Offer Tariffs be exempt from payment of transition costs. The
11 apparent rationale is that they are already paying stranded costs as part of the standard offer
12 tariff. I believe that this is a sustainable proposition only if the Commission is able to closely
13 coordinate a variety of factors that are likely to prove elusive. The Commission recognizes
14 that it cannot predict how long a period will elapse before it determines that competition has
15 been substantially implemented for a particular class. I can envision circumstances in which
16 the process will go rather quickly for some classes and be far more protracted for others.
17 Assuming that the over-arching policy objective is to have every customer class pay its "fair
18 share" of transition costs and avoid cost shifting between classes, how will the Commission
19 set the transition component of the standard offer tariff and coordinate it against the recovery
20 being paid by customers who have current competitive options?

21 **Q38. The Stranded Cost Working Group also was concerned with the stranded cost liability**
22 **of what are termed "customers are not taking competitive power." Do you support**
23 **their recommendations on this subject?**

24 A. I believe so, though I would prefer Option A at page 44 of the Working Group Report to the
25 consensus preference for Option B. As I read the report, the voting members reached
26 consensus on two recommendations. The first was that such individuals pay stranded costs
27 but that the charge take into account contributions that are already being made toward
28 stranded costs. The second was that this payment should not cause customers' prices to
29 increase. I clearly agree with the first proposition for it would be fundamentally unfair to
30 double charge. The second proposition is, in essence, some form of rate cap and should be

1 candidly addressed under Item 8. Suffice it to note at this point that in a truly competitive
2 market for generation, I do not think that the Commission can represent to the People of
3 Arizona that prices will surely or can only fall. They may rise. If this is the case the
4 Commission will be forced to pass such economic reality onto customers who elect to remain
5 with the Standard Offer. In saying this I recognize that a rising market price for generation
6 should work to diminish any claim to stranded costs arising from generation assets, but we
7 must not forget that there are other components, such as regulatory assets and potentially
8 nuclear decommissioning costs, which may be included in the basket of utility claims to
9 transition recovery.

10 **ISSUE 3. WHAT COSTS SHOULD BE INCLUDED AS PART OF "STRANDED COSTS" AND HOW SHOULD**
11 **THOSE COSTS BE CALCULATED?**

12 **Q39. Do you agree with the recommendation of the working group that stranded costs may**
13 **include: generation assets; power purchase agreements; fuel contracts; regulatory**
14 **assets; employment transition costs; and environmental mandates?**

15 **A.** In the main I do. As evidenced by my views while I was on the California Commission, I
16 clearly believe that a cost recovery mechanism should be adopted to give the utilities a fair
17 opportunity to recover their yet-to-be realized investment in generation assets, and that they
18 be held harmless against any over-market purchases made pursuant to existing contracts with
19 non-utility providers and entitled to an honoring of all prior Commission commitments on
20 regulatory assets. I firmly agree with the provisions of the California Order covering
21 employment transition costs because the reforms we are contemplating not only disturb the
22 climate in which investment plans were made, but they also assail the foundations of many
23 human choices in terms of careers and employment. I share Oliver Goldsmith's gloomy view
24 of any society that puts capital investments ahead of human investments.

25 **Q40. What about the inclusion of "environmental mandates"?**

26 **A.** I would be cautious on this issue. The inclusion of compliance with environmental mandates
27 as stranded costs, in my opinion, needs more discussion. There is a possible, but not
28 inevitable, corollary between the increased role of competitive discipline in the generation
29 market and enhanced environmental costs. I am aware of opponents of competition who
30 claim disaster lurks around the corner of any market that is driven by price considerations. I

1 share a concern but cannot join in the use of terms like "disaster." In such a future market all
2 entrants should be responsible for compliance with state and federal environmental mandates
3 and will doubtlessly seek to recover any associated costs in the prices they charge customers.
4 But to include them in "transition costs" suggests that they had been incurred under the old
5 regulatory regime, and if this is sound, it argues for a cut off date after which utility
6 expenditures on environmental enhancements to assets they retain for use in a competitive
7 market would be expenditures of shareholders and at risk for collection in prices not stranded
8 costs.

9 **Q41. The Working Group was unable to reach consensus on the method for computing**
10 **stranded costs. Staff has recommended that the Commission go forward using what it**
11 **terms a "Net Revenues Lost" approach. Do you agree with this recommendation?**

12 **A.** Here we strike directly at the difference between the suggested use of an administrative
13 calculation methodology and California's strong preference for a market valuation strategy. I
14 would note initially, that the Working Group's concept of market valuations was limited to
15 what it termed "auction and divestiture" and "stock market valuation" approaches. As
16 explained in my answer to Q22, California has labored to develop a third approach, one that
17 compares the performance of the potentially stranded asset or contract to the terms of the
18 competitive market as revealed in the Power Exchange. As a second point, I again draw the
19 Commission's attention to the results of the auctions for generation assets held by SCE and
20 PG&E. In each case the real money changing hands between willing buyers and sellers in
21 arm's length transactions has dramatically exceeded the recent estimates and net book values.
22 Whether this trend can be sustained or is the fate of those entities first to reach the market
23 with sale offerings remains to be seen. These results should be studied and then compared to
24 the parties opposed to a divestiture strategy at page 25 of the Working Group Report.

25 Having made these points, if the Commission opts for an administrative calculation
26 methodology, the top-down quantification known as the "net revenues lost" approach, which
27 commanded the greatest support in the Working Group and constitutes the Staff
28 recommendation, is one with which I would not quarrel. Surely I am a supporter of a "net
29 figure" approach, one that takes into account all generation costs and assets and credits those
30 which prove economical against those which do not. And, it will not surprise you that I am

1 an advocate of true-up proceedings and especially if you are using an administrative forecast
2 which admittedly is an educated guess performed in good faith against a host of variables. It
3 would appear that the Staff is prepared for the contentious administrative proceeding which is
4 likely to ensue, and it will be for you to determine if the drain on the Commission's resources
5 occasioned by such a proceeding is, given other demands on your time and attention,
6 warranted.

7 I fear that use of a replacement cost valuation premised on comparing all generation
8 assets to gas fired combustion turbines places too much emphasis on a single technology.
9 While it may be true that such an approach was utilized by California utilities in their initial
10 transition cost estimate, it is vital to understand the very limited use of that projection. These
11 estimates are prepared in California each year during the transition period, not on a one-time
12 basis. The initial administrative projection in California of a 2 and 1/2 cent clearing price for
13 generation was a proxy to be used only until it could be supplanted by factual data derived
14 from the Power Exchange.

15 **Q42. In his prepared testimony, Mr. Charles Bayless has suggested a benchmark for a**
16 **market clearing price that may avoid some of the guesswork. He proposes using the**
17 **Dow Jones Palo Verde Index as a market price proxy. Do you think that this is a good**
18 **idea?**

19 **A.** Yes, because it appears to be an established means of tracking the market price for energy
20 most likely to reflect the value of average fuel and variable O&M costs for generators serving
21 or capable of serving the Arizona market. If such a reference is used, I suggest that it not be
22 as a "snap shot" but rather through a tracking mechanism similar to the use of the Power
23 Exchange in California. Here I am attempting to respond to the concerns recounted in the
24 Working Group Report that the Palo Verde Index might initially reflect non-sustainable price
25 patterns as new market entrants vied for attention. If such marketing strategies do take place
26 as competition is introduced, they are part of reality and their duration or lack of
27 sustainability is also part of an unfolding reality. The virtue of a reference such as the Palo
28 Verde Index is the ability it affords the Commission and stakeholders to track these
29 developments during the calculation period.

30 ...

1 **ISSUE 4. SHOULD THERE BE A LIMITATION ON THE TIME FRAME OVER WHICH "STRANDED**
2 **COSTS" ARE CALCULATED?**

3 **Q43. You have reported that the California Plan limits the time frame over which stranded**
4 **costs are calculated and that the subsequent legislation shortens this period. Do you**
5 **believe that any limitation should be included in an Arizona Plan?**

6 **A.** Yes, because I believe that this incents the utilities to mitigate their costs, an important
7 Commission objective. I am aware that this puts me at cross purposes with the Staff
8 Recommendation on issues over which there was no consensus in the Working Group. In a
9 moment I will indicate qualified agreement with the proposition that, provided that the
10 Commission creates a non-bypassable collection methodology for all historic and new
11 customers, it should also establish a limitation on the recovery time frame. The working
12 group is surely correct in suggesting a link between the calculation and recovery periods or
13 deadlines. I simply want to emphasize a third related factor and that is the collection
14 vehicle.

15 When I read the Report of the Working Group I initially failed to see how the Staff
16 could at once favor a calculation period tied to the original life span of the generation asset
17 and then indicate that it has no objection to limiting to a period of from 3-7 years the
18 recovery period. In my mind the proper order was reversed with the limitation on the
19 calculation period arising first in time to be followed by the close of the opportunity to
20 collect the stranded costs. Upon further reflection I now see that this is a significant point in
21 which the Arizona Plan may pursue a different avenue than the one taken in California.
22 There, in an attempt to quickly assess transition costs associated with stranded generation, the
23 Commission ordered the utilities to reveal the dollar figure of their yet-to-be recovered equity
24 and debt capital invested in individual assets. The next step was to track the performance of
25 these assets in the Power Exchange and to determine what supplement, if any, would have to
26 be added to these revenues if the utility were to reclaim that investment by the deadline set
27 for collection. So the goal of the California reform was to give the utilities a realistic chance
28 to recover their invested capital. But it did not embrace allowing them to recover on that
29 investment. Let me put the point another way. The California Plan distinguished between a
30 return *of* capital and a return *on* capital.

1 By contrast, the Net Revenues Lost approach seeks to protect the expectations formed
2 under the existing regulatory regime with respect to both the recovery of an investment and
3 the income stream on that investment. This being the case, the Staff recommendation is quite
4 sensible respecting the calculation period and I have no difficulty supporting it.

5 **ISSUE 5. SHOULD THERE BE A LIMITATION ON THE RECOVERY TIME FRAME FOR "STRANDED**
6 **COSTS"?**

7 **Q44. The Working Group was unable to arrive at a consensus on this question. California**
8 **imposes such a limitation, do you believe that it should be a feature of the Arizona**
9 **Plan?**

10 **A.** Yes, provided that the Commission allows pursuit of collection using a non-bypassable
11 charge to be paid by every customer historically interconnected to the system of the claiming
12 utility whether power is supplied by that utility, an alternative supplier, or is self-generated
13 and the time frame is sufficient for stranded cost recovery.

14 **ISSUE 6. HOW AND WHO SHOULD PAY FOR "STRANDED COSTS" AND WHO, IF ANYONE, SHOULD**
15 **BE EXCLUDED FROM PAYING FOR STRANDED COSTS?**

16 **Q45. The Working Group has recommended that stranded costs should be recovered from**
17 **all historic and future ratepayers using a non-bypassable charge allocated to**
18 **jurisdictions and customer classes in a manner consistent with the specific company's**
19 **current rate treatment of the stranded asset. California has sought to impose a non-**
20 **bypassable charge which is also devoid of exceptions. Is this your recommendation for**
21 **Arizona?**

22 **A.** Yes, as I have repeatedly stated, I believe that restructuring initiatives do not create stranded
23 costs, they are already embedded in rates being paid by all Arizona ratepayers. To the extent
24 that these rates reflect utility investments and power purchase and fuel contracts and
25 regulatory assets approved by the Corporation Commission, they are the existing
26 responsibility of ratepayers. I respectfully suggest that this fundamental point should never
27 be lost as the debate moves forward and the Commissioners arrive at their decisions. The
28 virtue of the Working Group recommendation is that the charge is made utility specific which
29 promotes recovery of stranded costs in substantially the same proportion as the recovery of
30 current costs from customers or customer classes under current Commission approved rates.

1 The rationale for this result is that the components recognized for potential recovery
2 represent investments, contracts and regulatory arrangements incurred for all present and
3 future users of each utility's system. To allow any individual or class to evade a fair share is
4 simply to reallocate these costs to others. It is unfair and for that reason highly contentious.
5 To my mind to hold forth the prospect of exclusion from this burden as akin to hosting one of
6 the currently fashionable cigar smoking parties in an ammunition dump. It is irresponsibly
7 dangerous.

8 **Q46. The Working Group reported a consensus that ratepayers be given the option to settle**
9 **their stranded cost liability in a lump sum payment. What is your view?**

10 **A.** I am unaware that this idea was presented in California. My only caution centers on the issue
11 of calculation. If the calculation period is going to be several years and the opportunity for
12 collection also extended for a time certain, how can the Commission accurately calculate a
13 lump sum? To the extent that you adopt a plan featuring true-ups how would this
14 recalculation impact upon the liability of an individual who could not be proved to have
15 overpaid or underpaid the transition charge?

16 **ISSUE 7: SHOULD THERE BE A TRUE-UP MECHANISM AND, IF SO, HOW WOULD IT OPERATE?**

17 **Q47. The Working Group was unable to form a consensus on whether such a mechanism**
18 **while the Staff reports a strong recommendations annual true-ups. What is your**
19 **recommendation?**

20 **A.** So long as the Commission relies on an administrative method to calculate stranded costs, I
21 agree with the Staff that the variables within that prediction are too many and the risk of over
22 or under collection too great to ignore. Whether the true-up should be annual depends, in my
23 mind, on the time frames established for calculation and collection of transition costs. If
24 these time frames are fairly short, annual true-ups are probably warranted. On the other hand
25 if they are protracted, the true-up proceedings might be held on an every-other-year basis.

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1 **ISSUE 8: SHOULD THERE BE PRICE CAPS OR A RATE FREEZE IMPOSED AS PART OF THE**
2 **DEVELOPMENT OF A STRANDED COST RECOVERY PROGRAM AND IF SO, HOW SHOULD IT**
3 **BE CALCULATED?**

4 **Q48. California has imposed a price cap as part of its Restructuring Plan and the Working**
5 **Group achieved consensus that the Commission consider adoption of some type of a**
6 **“rate cap.” What is your view?**

7 **A.** Although I voted for such a feature in the California Plan and it would appear that the State
8 has won its bet with the uncertain factors of weather, it is not automatic in my mind that
9 Arizona include such a feature. As I noted in the introduction to my testimony, the
10 California plan was considered and framed against an economic crisis in which above
11 national average prices for energy threatened our embattled agricultural, commercial and
12 industrial consumers. The Commission opted for a rate cap. The Legislature converted this
13 into a rate freeze. The difference is significant. Under the Commission’s cap, a utility could
14 reduce its rates below the historic number but it could not exceed it. As noted in my earlier
15 description of the California Order, the presence of the cap shifted risk of future market
16 developments from ratepayers to shareholders. The Legislature’s preference for a freeze is,
17 to my mind, more beneficial to the utilities for it shields them from a comparative if not a
18 competitive pressure. Finally, as noted, the Legislature introduced the notion of a 10% rate
19 reduction as part of the securitization strategy.

20 The defect in these California strategies is that they contradict the central theme upon
21 which restructuring is being pursued: an increased reliance upon the discipline of market
22 forces and a greatly reduced ability of government to affect the economic terms of service by
23 decrees. This inherent contradiction has not been lost on many critics of the California plan.
24 What is right for Arizona? It obviously depends on facts and circumstances of which you
25 have an expert knowledge and I only a smattering of information. To the extent that the costs
26 of energy in Arizona are not in crisis, the Commission may feel that it can be more
27 systematic and faithful to a market disciplined approach to the cost of generation. I also
28 suggest that much will depend upon your confidence that you have discovered a means of
29 delivering the savings which would result in enhanced efficiency of generation and use of
30 transmission assets to average ratepayers.

1 **ISSUE 9: WHAT FACTORS SHOULD BE CONSIDERED FOR "MITIGATION" OF STRANDED COSTS?**

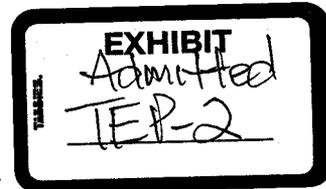
2 **Q49. The Working Group was unable to reach consensus on this matter and the Staff has**
3 **come up with a very inclusive concept of what it expects of the utilities as mitigation**
4 **measures. Have you views on this subject?**

5 **A.** I strongly support the duty to mitigate both as a former regulator and retired contracts
6 teacher. The goal of the restructuring is to enhance economic efficiency while maintaining
7 fairness in the electric service industry. That goal is pursued if the utilities are incented to
8 mitigate their stranded cost claims and other entities such as the holders of what are likely to
9 be over-market power purchase of fuel contracts are also incented to bring the terms of these
10 agreements to "market."

11 There is one point on which I disagree with the Staff's recommendation and that is
12 the policy of seeking to include as successful mitigation earnings that the utility management
13 might earn in a restructure market from business pursuits outside of Arizona which did not
14 involve the use of ratepayer funds or other assets. In contemplating restructuring the
15 Commission is fostering a new regulatory bargain. Part of the "consideration" furnished the
16 historic utilities is a greater freedom to manage their business as a business. The Standard
17 Offer bundled obligations of the Commission's Rules represent an aggressive pursuit of the
18 welfare of Arizona ratepayers. But to seek to claim for ratepayers the benefits of totally
19 unrelated going forward business pursuits for which they are to have no risk is unfair and, in
20 my view, unsound. It does not incent the Utilities to contain costs, it merely penalizes them
21 with off-sets rather than mitigation charges.

22 **Q50. Does this conclude your testimony?**

23 **A.** Yes.
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DIRECT TESTIMONY OF DANIEL WM. FESSLER

SUMMARY

Drawing upon my experience with the Restructuring in California, I trace the outlines of the social, political and economic compromise crafted by the California Commission and Legislature. The testimony reviews the major features of the California Order and AB 1890, showing how they dealt with the potential that an increased reliance upon market forces would strand utility investments, power and fuel purchase contracts, environmental and social programs which had been adopted by the Commission in its classical regulatory regime. I next examine the legal, economic and moral claims that costs which have already been deemed prudent and assumed as ratepayer liabilities should not be shifted in the course of restructuring.

Following this analysis of what was debated and done in California, I turn attention to the status of the social compact between the People of Arizona, the Corporation Commission and the investor owned electric utilities. I find that the duty to serve has been defined in the Constitution of Arizona, amplified in legislation aimed at public service corporations and made a living presence by the interaction of those utilities with the Corporation Commission. The testimony also identifies a wholly independent basis, unknown in California, but well established in the decisional law of Arizona. This is the common law duty to serve, a duty which clearly obligates utilities to serve all present and to be anticipated future patrons. I then expressed the view that the utility investments in generation and assumption of contract liability for electricity and fuel were undertaken in the context of this duty to serve and regulatory environment and that while the Commission is to be applauded for its interest in altering that environment to pursue efficiency gains through competitive discipline, it is obligated to keep faith with its past commitments.

In Part 3, I take up more specifically the issues identified in the Procedural Orders relating to stranded costs. My testimony recommends some changes in the Commission's Electric Competition Rules to clarify that the investor-owned utilities are entitled to a fair opportunity to recover the debt and equity investments in generation facilities, and be held harmless against any over-market costs associated with honoring fuel and power purchase contracts, and collect on the established regulatory assets. It advocates the use of a non-by passable competition transition charge to be imposed on all historic and future electric users in

the service territories of the investor owned utilities. Such a charge should be administered to reflect existing allocation under current ratemaking so that the move to competition does not result in cost shifting between or among customer classes. I suggest that the Net Revenues Lost calculation methodology be refined by using a benchmark, such as the Dow Jones Palo Verde Index, to track the emerging value of generating capacity in the Arizona market.



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-00000C-94-0165
THE PROVISION OF ELECTRIC SERVICES)
THROUGHOUT THE STATE OF ARIZONA.) **REBUTTAL TESTIMONY OF**
) **DANIEL WM. FESSLER**
)
_____)

On Behalf of
TUCSON ELECTRIC POWER COMPANY

FEBRUARY 4, 1998

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INTRODUCTION AND PURPOSE

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- Q1. Please state your name, affiliation and business address.**
- A. My name is Daniel Wm. Fessler. I am a partner in the law firm of LeBoeuf, Lamb, Greene & MacRae. My address is One Embarcadero Center, San Francisco, California.
- Q2. On whose behalf are you appearing in this proceeding?**
- A. Tucson Electric Power Company.
- Q3. Have you filed other testimony in this proceeding?**
- A. Yes, I filed direct testimony.
- Q4. Have you had an opportunity to review the prefiled testimony of the various parties to this Rulemaking?**
- A. Yes, I have reviewed the direct testimony of 26 witnesses representing a wide variety of interests. As a former regulator who has heard and weighed social, political, legislative and legal arguments in an effort to frame and defend the public interest, I was disappointed in some of the myopic and revisionist positions taken by various witnesses. In my direct testimony, and again today, I rely upon these broad ranging disciplines to form my conclusions and recommendations regarding matters at issue in this proceeding.
- Q5. Have you formed any opinion on whether the positions taken by these various stakeholders exhibit the degree of consensus which you and your colleagues found necessary to advance the introduction of competition in California?**
- A. Unfortunately, they do not. Indeed, the range of opinion on such vital issues as whether there is a regulatory compact which must be respected and, if so, the consequences of such a compact is wider in scope and more vociferous in tone than anything I can remember in the nearly four years in which these issues were debated in California. I find this particularly troubling because we are now less than 11 months from the point at which the Commission Rules call for the introduction of competition. Unless these hearings are able to move the various stakeholders to a constructive resolution of these issues, I fear for the timely introduction of competition in Arizona.

...
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...

1 **Q6. You have expressed “fear for the timely introduction of competition in Arizona,” but**
2 **isn’t it the case that the Commission can decree such a result notwithstanding the**
3 **degree of disagreement among the stakeholders?**

4 **A.** My reading of Dr. Rose’s testimony suggests that this may be his position. In my view, any
5 attempt to force so fundamental a change on such unwilling parties would be unsound in its
6 assessment of the Commission’s constitutional authority and utterly implausible in terms of
7 pragmatic consequences. Consistent with the view that I articulated at the beginning of the
8 California restructuring, I continue to maintain that the replacement of vertically integrated
9 monopolies with a disaggregated industry dependent on the discipline of competition in the
10 field of generation cannot be accomplished in the absence of a strong consensus. I
11 respectfully suggest that in Arizona, as in California, the Commission’s worthy goals lie
12 beyond the reach of decrees and orders. If they are to be attained and sustained the
13 Commission must be able to produce widespread participation and cooperation on the part of
14 the present and new market entrants. The alternative is as ugly as it is predictable. Any final
15 order of the Commission given in the face of substantial opposition will inevitably result in
16 judicial appeals that frustrate rather than fulfill the ambitions which the Commission has
17 framed for the People of Arizona.

18 **Q7. For the purposes of this rebuttal testimony, how do you propose to focus your efforts**
19 **and order your suggestions to the Commission?**

20 **A.** I am going to concentrate on the related issues of whether restructuring must take into
21 account the existence of a “regulatory compact” or “contract” and, since I will contend that it
22 must, the implications of that compact on the terms of the Commission’s final restructuring
23 policies and implementation strategies. I will focus my rebuttal submission on the testimony
24 of Dr. Kenneth Rose for the Arizona Corporation Commission Staff, Dr. Eugene P. Coyle for
25 the City of Tucson, Dr. Richard Rosen for the Residential Utility Consumer Office, and Mr.
26 Kevin C. Higgins for Arizonans for Electric Choice, et al. Drs. Rose and Coyle have filed
27 testimony which asserts that there is no regulatory contract or compact and concludes that
28 recognition of stranded costs and provision for a recovery opportunity for the Affected
29 Utilities is a matter of grace wholly within the Commission’s discretion. Dr. Rose, Dr.
30 Coyle, Dr. Rosen and Mr. Higgins offer the view that, if stranded costs are recognized, the

1 Affected Utilities not be accorded an opportunity to recover 100% of the funds invested in
2 generation units built and deployed in the service of ratepayers under an era of de jure
3 monopolies. I respectfully disagree with each of these contentions. I will conclude with the
4 views of Dr. Coyle and Dr. Rose on the advisability of securitization as a feature of any final
5 Rules.

6 THE REGULATORY COMPACT

7 **Q8. Could we begin with your reaction to the contentions that the regulatory contract or**
8 **compact is a recent, self-serving invention of the utilities?**

9 **A.** Yes, for this issue lies at the heart of the reform effort insofar as the Affected Utilities are
10 concerned. It is clear that Dr. Coyle is a believer in the recent invention theory
11 notwithstanding his candid recognition that: “[i]t is fundamental to the whole issue of
12 Stranded Costs to note that there is a valid debate over the legal right of the Affected Utilities
13 to recovery of full stranded costs.”¹ I also find rhetoric in Dr. Rose’s testimony which
14 partakes of the same denial. However, upon closer reading I am not convinced that Dr. Rose
15 is urging that the Commission risk the fate of the restructuring on such a gambit.

16 **Q9. In his filed testimony, Dr. Coyle informs the Commission that, to his knowledge, “the**
17 **phrase a ‘regulatory compact’ did not appear in printed books and articles until**
18 **deregulation and the issue of stranded cost became important to utilities. [Dr. Coyle’s]**
19 **conclusion is that the notion of a ‘regulatory compact’ is a recent invention which is**
20 **used to, but does not, justify ‘stranded cost.’”² Do these sentiments accord with your**
21 **own knowledge?**

22 **A.** No, I find printed references to the “regulatory compact” a decade before the subject of
23 restructuring the electric services industry gained currency. The term is used by Judge (now
24 Associate Justice) Scalia in *New England Coalition on Nuclear Pollution v. Nuclear*
25 *Regulatory Comm’n*. 727 Fed.2d 1127, 1130 (D.C. Cir. 1984) where he characterizes a
26 “. . .compact whereby the utility surrenders its freedom to charge what the market will bear in
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30 ¹ Dr. Coyle at p. 5, lines 11-13.

² Dr. Coyle at p. 13, lines 4-8.

1 exchange for the state's assurance of adequate profits. . . ." In the same year the phrase was
2 used by the Washington Utilities and Transportation Commission:

3 Understanding the dichotomy between the treatment of expenses prudently
4 undertaken to provide service and providing return on investment and that
5 they are two separate matters is critical to the understanding of the regulatory
6 compact and the operation of the utilities.

7 *Washington Utils. & Transportation Comm'n. v. Puget Sound Power & Light Co.*, 62
8 PUR4th 557, 581.

9 **Q10. Does the term "regulatory contract" have a history of use prior to the debate over**
10 **stranded costs?**

11 A. Yes, the term has been in use for nearly 120 years. Indeed, it is more widespread than
12 references to the "compact" because the term "contract" has a much more defined meaning in
13 the political and legal history of the United States. Those who charge that the "regulatory
14 contract" is a recent invention of the utilities - deployed as a self-serving prop for the asserted
15 right to a reasonable opportunity to recover their stranded costs and be held harmless against
16 stranded liabilities - make these claims in the face of fact. I do not doubt their good will, but
17 I can prove that they are guilty of gross error. This proof requires that I ask the Commission
18 to take notice of judicial decisions which have established, upheld and clarified the existence
19 of the regulatory compact or contract. These cases are matters of public record, and are
20 brought to the Commission's attention to conclusively show that: (a) the terms have, in fact,
21 been used for decades; (b) had Dr. Coyle checked the public record and available literature he
22 would have known that neither term is a "recent invention"; and (c) the judicial
23 understanding of the regulatory contract is one of enforceable limitations on the discretion of
24 government rather than the social arrangement claimed by some witnesses.

25 One hundred and thirteen years ago the United States Supreme Court issued a short,
26 unanimous and definitive decision on the implications of a utility franchise granted by a state
27 or one of its instrumentalities. The plaintiff had obtained a franchise granting it the exclusive
28 right to supply the citizens of New Orleans with water for domestic consumption for a period
29 of 50 years. Prior to the expiration of this time period the state amended its constitution to
30 prohibit monopolies, and the city government sought to authorize a competitor. The utility

1 commenced suit in the United States District Court seeking an equitable decree prohibiting
2 the new entrant from laying pipes or otherwise seeking to serve customers within what it
3 claimed to be the territory of its exclusive franchise. The trial court ruled in favor of the
4 defendant recognizing the authority of the state to change its mind and the city to grant
5 competitive entry. On appeal the Supreme Court unanimously reversed this decision.

6 . . . The right to dig up and use the streets and alleys of New Orleans
7 for the purpose of placing pipes and mains to supply the city and its
8 inhabitants with water is a franchise belonging to the State, which she
9 could grant to such persons or corporations, and upon such terms, as
10 she deemed best for the public interest. . . . Such was the nature of the
11 plaintiff's grant which, not being at the time prohibited by the
12 constitution of the State, was a contract, the obligations of which
13 cannot be impaired by subsequent legislation, or by a change in her
14 organic law. It is as much a contract, within the meaning of the
15 Constitution of the United States, as a grant to a private corporation for
16 valuable consideration, or in consideration of the public services to be
17 rendered by it, of the exclusive right to construct and maintain a
18 railroad within certain lines and between given points, or a bridge over
19 a navigable stream within a prescribed distance above and below a
20 designated point.

21 *New Orleans Water-Works Co. v. Rivers*, 115 U.S. 674, 681 (1885).³

22 Precisely 100 years ago, the same debate shifted to the west and produced exactly the
23 same reaction from the Court. In *Walla Walla City v. Walla Walla Water Co.*, 172 U.S. 1
24 (1898), the city had granted a 25 year franchise to the water utility under terms of which it
25 was to build infrastructure and furnish water for domestic consumption and fire fighting
26 purposes. An express term of the grant provided that the city would not construct or
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28 ³ The Court dismissed as "idle" fears that the grant of such a franchise was prejudicial to public health or safety
29 holding that the state police power was always sufficient to protect those interests against private property uses and
30 claims. The object sought by the altered constitution and city council resolution was a new economic arrangement
not a safety or health concern. Such a step was beyond the legislative authority of the State of Louisiana or its
political subdivisions.

1 purchase its own water works unless it had first obtained a judgment from a court of
2 competent jurisdiction that the utility was in breach of its service obligations. Before the
3 expiration of this term, and without initiating litigation to secure a judgment that the utility
4 was in default as to any service obligation, the city sought to issue bonds to finance a
5 municipal water works. The utility commenced suit in federal court to enjoin the city and its
6 officers, claiming that the municipal water works scheme would impair the obligation of a
7 contract in violation of Article I, Section 10, Clause 1 of the United States Constitution. The
8 trial court granted the injunction and, on appeal, the United States Supreme Court affirmed.
9 In the course of a unanimous opinion the Court declared:

10 . . . this court has too often decided for the rule to now be questioned,
11 that the grant of a right to supply gas or water to a municipality and its
12 inhabitants through pipes and mains laid in the streets, upon condition
13 of the performance of its service by the grantee, is the grant of a
14 franchise vested in the State, in consideration of the performance of a
15 public service, and after performance by the grantee, is a contract
16 protected by the Constitution of the United States against state
17 legislation to impair it.

18 172 U.S. at 9.

19 **Q11. Has the regulatory contract been expressly recognized and defined by the Supreme**
20 **Court of Arizona?**

21 A. Yes. In a widely reported and often cited case, *Trico Electric Cooperative, Inc.*, 92 Ariz.
22 373, 377 P.2d 309 (1962), the Supreme Court recognized and defended the regulatory
23 contract. The dispute was over service territories with Trico claiming that it had achieved the
24 status of a public service corporation with a territory which included the area being claimed
25 by Tucson. The immediate goal of the litigation was Trico's attempt to secure a writ of
26 mandamus compelling the Commissioners to approve a contract which Trico had formed
27 with a real estate developer who was building a project in a previously uninhabited portion of
28 Trico's service territory. Finding no evidence that the Commission had conducted a Section
29 40-252 proceeding to rescind, alter or amend Trico's certificate of convenience and necessity,
30 the trial court granted the writ. On appeal, the Supreme Court unanimously affirmed and, in

1 the course of its opinion, removed several issues from contention insofar as the decisional,
2 statutory and constitutional law of Arizona is concerned:

3 In the performance of its duties with respect to public service
4 corporations the Commission acts as an agency of the State. By the
5 issuance of a certificate of convenience and necessity to a public
6 service corporation the State in effect contracts that if the certificate
7 holder will make adequate investment and render competent and
8 adequate service, he may have the privilege of a monopoly as against
9 any other private utility. Trico's right to maintain its distribution lines
10 in the area of its certificate, and to make extensions therefrom to
11 customers resulting from the development of the area served by it, is a
12 vested property right, protected by Article 2, Section 17, of the
13 Arizona Constitution.

14 **Q12. The position of the Commission Staff, as presented in the testimony of Dr. Rose, asserts**
15 **that “[t]he term regulatory compact, properly understood, does not refer to an implied,**
16 **implicit, or explicit contract. Properly understood, the term regulatory compact is a**
17 **metaphor that refers to the nature of regulation of a regulated monopoly.”⁴ Do you**
18 **agree with this statement?**

19 **A.** We are faced with two assertions. In my view the first is demonstrably wrong while the
20 second may provide a key to some common ground.

21 The Staff view that a proper understanding will lead to the conclusion that there is no
22 “implied, implicit, or explicit contract” is one I do not share. More importantly, if my
23 understanding is “improper” I take comfort that it mirrors the view of the Supreme Court of
24 Arizona. Any infrastructure investment made by a public service corporation in this state
25 since 1962 has been in the context of the Court's express recognition of a contract with the
26 State undertaken on behalf of the public. *Trico Electric Cooperative, Inc.*, 92 Ariz. 373, 377
27 P.2d 309 (1962).

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⁴ Dr. Rose at p. 2, lines 4-6.

1 The second assertion, that we are dealing with a “metaphor that refers to the nature of
2 regulation of a regulated monopoly,” is one that I can accept if we then go on to a factual and
3 complete revelation of the key terms “nature of regulation of a regulated monopoly.” *Trico*
4 *Electric* is a good starting point because the Court did not mince words. Public service
5 corporations formed a contract with the State of Arizona which acted through the agency of
6 this Commission. As certificate holders the utilities were bound to “make adequate
7 investment and render competent and adequate service.” So long as the utility keeps faith
8 with those service obligations, the State is obliged to protect and defend a monopoly service
9 territory. The *Trico* court was equally blunt as to the circumstances in which the vested
10 property right to an exclusive service territory could be altered:

11 Quite aside from statutory requirements the rescission or revocation of
12 all or a portion of a certificate of public convenience and necessity requires
13 strict compliance with the procedural prerequisites of notice and hearing. The
14 Commission’s power to grant, amend, or cancel certificates of convenience
15 and necessity is limited to that expressly granted by the Constitution and laws
16 of Arizona.

17 92 Ariz. 373, 381, 377 P.2d 309, 315.

18 I respect the fact that Dr. Rose has made his response as a “non-attorney,” but the
19 existence of judicial decisions is a fact, and their content part of the public law of Arizona
20 open for the inspection of all and obligatory on all as citizens irrespective of the manner in
21 which we make a livelihood. My recommendation to the Commission is that it move the
22 debate beyond the semantics of “compact” vs. “contract” and simply face up to the regulatory
23 consequences of an honorable history of “regulated monopolies.” The occasion for our
24 current discussion is the Commission’s desire to break from that history and seek the public
25 advantage in new arrangements. Dr. Rose tells us that: “We must be clear that the social
26 compact is not now, nor has it ever been a contract guaranteeing the utility a perpetual
27 monopoly, freedom from competition or full cost recovery.”⁵ Tucson Electric Power has
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⁵ Dr. Rose at p. 3-4, lines 27-28 and 1.

1 never contended for any of these exaggerated claims. To first set them up and then attack
2 them is to divert attention from the business at hand.

3 **Q13. Is it your testimony that because the outstanding certificates of convenience and**
4 **necessity of the Affected Utilities enjoy recognition as contracts under decisions of the**
5 **Supreme Court of the United States and the Supreme Court of Arizona, Commission**
6 **sponsored efforts to introduce competition must be abandoned?**

7 **A.** No, that is not my position nor is it the position of Tucson Electric Power. The utility has
8 made it quite plain that it is prepared to cooperate in a fundamental amendment to its
9 certificate of convenience and necessity and to forego the monopoly privilege *if* the revised
10 regulatory regime and rules for the introduction of competition provide a reasonable
11 opportunity to recover its stranded costs, stranded liabilities, and regulatory assets. Provided
12 that the final Rules and Commission implementation strategies accord this opportunity, I
13 believe that they stand an excellent chance of surviving scrutiny under *United States Trust*
14 *Co. v. New Jersey*, 431 U.S. 1 (1997), the Court's most recent decision balancing the rights
15 of investors against the ongoing desire to pursue public health, safety, and evolved notions of
16 economic advantage. Even more important, given the Commission's announced
17 implementation target, the inclusion of the reasonable opportunity will ensure that these
18 issues will *not* be litigated by entities able to assert impairment of contract claims in federal
19 court and takings claims in state courts.

20 **Q14. If you regard compliance with *United States Trust v. New Jersey* as the key to**
21 **harmonizing the State's desire to move away from integrated monopolies and toward**
22 **competition in generation, can you explain the precise linkage to your conclusion that**
23 **the Rules and implementation strategies must provide the Affected Utilities with a**
24 **reasonable opportunity to recover their stranded costs, stranded liabilities and**
25 **regulated assets?**

26 **A.** Yes, but to do so I will have to provide a brief factual background on the dispute before the
27 Supreme Court. In 1962 the States of New Jersey and New York entered into a contract with
28 each other and the bondholders of the Port Authority in which the states agreed not to use the
29 revenues and reserves of the Port Authority to subsidize mass transit. In 1974, in the wake of
30 the OPEC embargo, the states opted for aggressive plans to solve urban transit problems as

1 well as excessive individual dependence on automobiles. A critical step in pursuit of these
2 goals was passage of parallel statutes repealing the prior limitation on the use of Port
3 Authority funds to subsidize mass transit. The Port Authority commenced suit claiming
4 impairment of contract. New Jersey state courts rejected the suit and, on appeal, a divided
5 Supreme Court reversed, holding the 1974 legislation in both states null and void as an
6 impairment of contract.

7 Writing for the majority, Justice Blackmun declared that for nearly a century the
8 impairment of contract clause had been read literally as an explicit Constitutional limitation
9 on state power. However, beginning in the 1930s the Court moved away from what he
10 termed a mechanistic approach toward a balancing test which sought to harmonize security
11 for investors and other contract parties with the ongoing need of state governments to
12 advance the health and safety of citizens. Indeed, the scope of legitimate state interests had
13 grown to include economic concerns. It was precisely on this point that the states sought to
14 defend their repeal. The Court responded:

15 Mass transportation, energy conservation, and environmental
16 protection are goals that are important and of legitimate public
17 concern. Appellees contend that these goals are so important that any
18 harm to bondholders from repeal of the 1962 covenant is greatly
19 outweighed by the public benefit. We do not accept this invitation to
20 engage in a utilitarian comparison of public benefit and private loss. . .
21 [A] State cannot refuse to meet its legitimate financial obligations
22 simply because it would prefer to spend the money to promote the
23 public good rather than the private welfare of its creditors. We can
24 only sustain the repeal of the 1962 covenant if that impairment was
25 both reasonable and necessary to serve the admittedly important
26 purposes claimed by the State.

27 . . . But a State is not completely free to consider impairing the
28 obligations of its own contracts on a part with other policy alternatives.
29 Similarity, a *State is not free to impose a drastic impairment when an*
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1 *evident and more moderate course would serve its purposes equally*
2 *well.*

3 431 U.S. at 29, 30 (emphasis added).

4 The missing ingredient which could have saved the otherwise Constitutionally
5 doomed New Jersey and New York legislation had been alluded to earlier in the majority
6 opinion:

7 . . . As a security provision, the covenant was not superfluous; it
8 limited the Port Authority's deficits and thus protected the general
9 reserve fund from depletion. *Nor was the covenant merely modified or*
10 *replaced by an arguably comparable security provision.* Its outright
11 repeal totally eliminated an important security provision and thus
12 impaired the obligation of the States' contract.

13 431 U.S. at 19 (emphasis added).

14 The implication for the Commission's competition strategy is clear: repeal of the opportunity
15 to recoup investments in generation plants admitted to ratebase, pass through costs of power
16 and fuel purchase contracts, and recover regulatory assets under traditional cost of service
17 ratemaking is not an impairment if it is accompanied by a comparable security provision to
18 protect the interests of utility shareholders. The opportunity to recover 100% of stranded
19 costs, stranded liabilities and regulatory assets is that reasonably comparable security
20 provision.

21 **Q.15. But the Staff position, as articulated by Dr. Rose, is that "states are free, at their**
22 **discretion, to provide compensation for uneconomic assets as some states have done.**
23 **But it is not a constitutional requirement as is often claimed."**⁶ This conclusion is
24 drawn from a number of explicit premises the most important of which is the
25 contention by Dr. Rose that ". . . the current regulatory process developed over the last
26 several decades was intended to act as a surrogate for competition, albeit an imperfect

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⁶ Dr. Rose at p. 3, lines 13-15.

1 one, since competition was itself viewed as impractical.”⁷ This contention is married to
2 an earlier assertion that a move to a competitive market is simply a superior “. . . means
3 to determine the fair value of utility assets and control costs. . . .”⁸ Finally, Dr. Rose
4 reviews the tools of what he describes as “the current regulatory process” and
5 concludes that they were an imperfect substitute for competition having failed to
6 provide regulators with “. . . all the necessary information needed to determine the
7 price for a utility’s services equivalent to a competitive market.”⁹ What is your
8 response?

9 A. I obviously disagree with the conclusion that the recognition of the “stranded costs” defined
10 in the Commission’s Rules is wholly discretionary. I have provided my reasons for
11 concluding that the classical regulatory contract limits the discretion of this Commission
12 under both the federal and state constitutions and that to ignore these limitations is to doom
13 the reform efforts to well-grounded legal challenges.

14 It is evident that our differing conclusions stem from differing premises. Dr. Rose
15 has not had an opportunity to study and comment on the cases which I have reported to the
16 Commission. I have had the opportunity to think on the premises which are advanced in
17 support of the Staff’s position. I respectfully suggest that they are a half truth pointing down
18 a blind alley. There is truth in the assertion that classical cost of service regulation was
19 intended to function as a substitute discipline for competition. I also share the Staff’s belief
20 that competitive market mechanisms will prove a superior discipline and that this is the long-
21 term public advantage being sought in restructuring the industry and regulation. But to
22 reduce the entirety of current regulation to an inherently flawed attempt to mimic market
23 forces in determining a “price for a utility’s service” is neither fair nor factual. It simply
24 ignores the key features of cost of service regulation which governed utility investment in
25 infrastructure.

26 There is no mention of the fact that the utility acted under Commission and statutory
27 imposed restraints that placed utility shareholders at substantial risk by limiting recovery to
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29 ⁷ Dr. Rose at p. 3, lines 16-18.

30 ⁸ Dr. Rose at p. 3, lines 9-10.

⁹ Dr. Rose at p. 3-4, lines 23 and 1.

1 only prudently incurred costs. Further, the opportunity to recover prudently incurred cost
2 was stretched out over a long amortization period fixed by the Commission for the
3 convenience of ratepayers. During this protracted period the utility was forbidden to realize
4 any more than a Commission set return on this investment. Add to this that all other aspects
5 of the utility's service were remunerated at Commission determined rates rather than market
6 forces and you have the elements of the picture which placed utility investors under
7 constraints that no unregulated counterparts faced. But there was symmetry to the classical
8 contract. So long as their investment vehicle retained its certificate of convenience and
9 necessity, utility investors could rely upon the resources of the service territory and rates that
10 were designed to provide an opportunity to recoup the reasonable expenses, recover
11 prudently incurred costs, and earn a return on that investment. This Rulemaking openly
12 contemplates repeal of the exclusive service territory and projects a future return on
13 generation investments and contract obligations that is set by markets. For investments and
14 contracts formed under this replacement set of institutions, I have no difficulty in seeing the
15 owners of market participants held to the risks and rewards of their venture. But we are
16 discussing prior investments and prior obligations and I repeat my view that the Commission
17 is obligated to keep faith with the contract it formed as the duly authorized agent of the
18 People of Arizona.

19 **Q.16. Dr. Rose, the Staff witness, and Mr. Kevin Higgins, on behalf of Arizonans for Electric**
20 **Choice and Competition et al., advance the theory that if there is an obligation to**
21 **provide an opportunity for the Affected Utilities to recover their stranded costs,**
22 **customers cannot be held liable because they did not cause the condition nor were they**
23 **obligated to continue as ratepayers to any given utility. Please comment on these**
24 **contentions.**

25 **A.** The Staff asserts that, if there was a duty to serve on the part of the utility, there "never was
26 nor is there now a concurrent obligation to buy on the part of customers of the utility."¹⁰ In
27 support of this proposition, Dr. Rose points out that if there was such a direct obligation the
28 utilities could have pursued individual customers who left the service territory or switched to
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¹⁰ Dr. Rose at p. 4, line 7-8.

1 self-generation. Again, there is an element of truth in this observation, but the net effect is
2 misleading. If we limit ourselves to the past and current regulatory model, it is true that
3 utilities did not pursue claims against departing customers. But it is equally true that the
4 Commission fixed rates designed to allow the utility to recoup its expenses, invested capital,
5 and return on equity from all remaining ratepayers. Once infrastructure costs had survived a
6 prudency review and been placed in the utility ratebase, it cannot be denied that rates were
7 designed to allow recovery and imposed on end users of electricity as the source of those
8 funds. The linkage to ratepayers was not hypothetical; it was very direct. While it is true that
9 a ratepayer was free to move out of the service territory, it is equally true that no ratepayer
10 could remain within the confines of a service territory and take electric service other than
11 from the certificated public service corporation. Again, this point was withdrawn from
12 controversy in Arizona with the Supreme Court's decision in *Trico*:

13 It would inevitably follow, from our determination, that Trico was a
14 public service corporation, that it is subject to all the burdens and entitled to
15 all the benefits which apply to public service corporations generally. The term
16 'public service corporation' implied service to the public.

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18 We hold that the Corporation Commission was under a duty to Trico
19 to protect it in the exclusive right to serve electricity in the region where it
20 rendered service, under its certificate. The Commission was under duty to
21 prohibit a private utility under its jurisdiction from competing in that area,
22 unless, after notice and an opportunity to be heard, it shall have been made to
23 appear that Trico failed or refused to render satisfactory and adequate service
24 therein, at reasonable prices.

25 92 Ariz. at 385, 387, 377 P.2d at 318, 319.

26 In summary the classical regulatory order existed for the benefit of the public and will
27 be replaced by a new alignment of providers and customers which represents the efforts of
28 the Commission to serve the public.

29 Mr. Higgins argues for a sharing of the financial burdens associated with stranded
30 cost recovery. I will address his notion of a 50/50 split in a moment, but first I would like to

1 spend time with his contention that it will be “competitive suppliers” and not “customers”
2 who will occasion stranded costs on the part of the Affected Utilities.¹¹ The proposition
3 confuses the instrument of change with the cause of change. This is puzzling given Mr.
4 Higgins’ clear understanding that “[s]tranded cost’ is a term used to refer to that portion of a
5 utility’s regulator-approved, generation-related fixed costs and regulatory assets which the
6 utility does not recover due to the introduction of a competitive generation market and the
7 resultant lower electricity prices.”¹² On the face of this definition is recognition that stranded
8 costs are occasioned by a change in regulatory policy which, as I have noted, is being
9 pursued for the presumed advantage of all Arizona ratepayers.

10 **Q17. Mr. Higgins¹³ and Dr. Rosen¹⁴ suggest a 50/50 sharing of any stranded cost liability**
11 **between ratepayers and the shareholders of Affected Utilities. In your opinion, would**
12 **such a provision meet the minimal test for a comparable security provision to protect**
13 **the interests of utility shareholders?**

14 **A.** No, such a provision would fail the comparability test by design. Again, we must begin by
15 reconciling ourselves to the existing regulatory policies and practices under which these
16 infrastructure investments and contract liabilities were incurred. As was clearly recognized
17 in the definition offered by Mr. Higgins, these investments and obligations already exist and
18 are currently the liability of Arizona ratepayers under cost of service ratemaking. This
19 liability is not for some arbitrary fraction but for rates designed to provide a fair opportunity
20 for the utility to recover all of its costs, recoup all of its investment and earn a return on
21 equity. To abolish this opportunity and replace it with one designed to permit a fractional
22 accomplishment of these critical objectives is, by definition, to impair the contract recognized
23 in *Trico* under terms designed to be nullified under the test enunciated in *United States Trust*
24 *v. New Jersey*.

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29 ¹¹ Mr. Higgins at p. 10, lines 4-5.

¹² Mr. Higgins at p. 5, lines 7-10.

¹³ Mr. Higgins at p. 11, lines 14-16.

¹⁴ Dr. Rosen at p. 69, lines 15-18.

1 Rose that estimates may turn out to be in error and have testified to that fact. But the remedy
2 is equally clear in my mind: design a securitization plan that issues the bonds in series with
3 an opportunity to decrease or increase subsequent issues in accordance with emerging data.
4 Another alternative is to provide for a reserve so that a portion of the proceeds would be held
5 in an account which would be credited to ratepayers in the event of over collection.

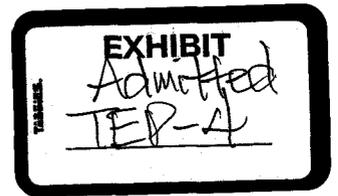
6 Aside from the notions of risk shifting, the Staff testimony asserts that "securitization
7 results in a large infusion of cash into the utility. . . . This money can be used in any manner
8 that holding company desires, including using it to restrict competition."¹⁸ We are not told
9 just how that thwarting of competition might be effected, but I suspect that Dr. Rose has in
10 mind some form of predatory pricing on the part of the cash infused utility. I have two
11 responses. First, predatory pricing is illegal and the appropriate societal response is to deal
12 with the offense if it takes place rather than preventing an entity from acquiring assets for
13 which there would be many productive and perfectly lawful uses. Second, in a market for
14 generation which features free entry and exit, predatory pricing would be nonsensical. Any
15 entity selling below cost into such a market will quickly discover that, while its competitor
16 may be forced out of business, the plant and equipment will not cease to exist but merely be
17 transferred to a subsequent rival with a dramatically enhanced competitive position.

18 When one confronts the suggested evils of securitization and finds them either non-
19 substantive or easily avoided, the Commission is left with an ability to pursue a plan which
20 will capture the benefits of lower financing costs while achieving another important goal
21 mentioned by Dr. Coyle. Securitization would enable the Commission to quickly and
22 decisively deal with past obligations while at the same time achieving generational equity by
23 spreading the burden over future users.

24 **Q.19. Does this complete your rebuttal testimony?**

25 **A.** Yes
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30 ¹⁸ Dr. Rose at p. 25, line 27 and p. 26, lines 2-3



REBUTTAL TESTIMONY OF DANIEL WM. FESSLER

SUMMARY

In this rebuttal testimony, I respond to the position taken by several witnesses that the regulatory compact or contract is a recently invented, self-serving concept devised by the Affected Utilities to justify recovery of stranded costs. In my rebuttal testimony I assert that the continued attempts to deny the existence of such a bargain threaten to mire the Commission's goal of introducing competition in generation by January 1, 1999 in federal and state litigation. I also contend that a failure of the Commission Rules and implementation policy to provide the Affected Utilities with a comparable reasonable opportunity to recoup 100 percent of their investments in: i) generation plants admitted to ratebase, ii) pass through the costs of previously formed power and fuel purchase contracts, and iii) regulatory assets, will provide the utilities with well founded claims of impairment of the regulatory contract and an impermissible taking of a vested property right.

In support of these contentions, I draw the Commission's attention to both classical and recent decisions establishing the fact that the regulatory contract has been recognized and defined by the United States and Arizona Supreme Courts.

The second aspect of my rebuttal testimony focuses on the consequences of the regulatory contract to the Commission's efforts to extinguish the vertically integrated monopoly features of the existing certificates of convenience and necessity and introduce competition in generation. I contend that state and federal constitutional protections do not prohibit this sweeping reform provided that the plan and its implementation strategies include a mechanism that is comparable to the reasonable opportunity afforded utilities under cost of service ratemaking to recoup their investments in ratebase, pass through costs associated with fuel and power purchases and recovery of their regulatory assets.

I next address the contention of several witnesses that the Commission Rules should be amended to create some sharing formula to apportion revenue losses resulting from the introduction of competition between utility shareholders and ratepayers. My position is that such a provision would flunk the comparability test by design, triggering certain impairment and takings litigation.

I conclude by refuting the Staff contention that a provision in the Commission's Competition Rules, which would permit securitization of the lost revenues, is contrary to the interest of ratepayers. I show that securitization may well lower the financing costs, while permitting an extension of the time frame over which a competition transition charge is collected from Arizona ratepayers. It is within the ability of the Commission to design a securitization plan that promotes generational equity without endangering the introduction of competition or risking over-collection of estimated lost revenues.

BEFORE THE ARIZONA CORPORATION COMMISSION

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

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

DOCKET NO. U-0000-94-165

**DIRECT TESTIMONY OF
KENNETH GORDON**

On Behalf of
TUCSON ELECTRIC POWER COMPANY

JANUARY 9, 1998

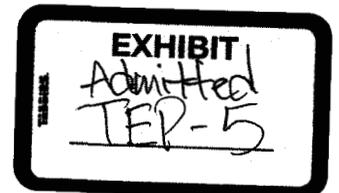


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DIRECT TESTIMONY OF KENNETH GORDON

I. QUALIFICATIONS

Q. PLEASE STATE YOUR NAME, ADDRESS, AND QUALIFICATIONS.

A. My name is Kenneth Gordon. I am Senior Vice President of National Economic Research Associates, Inc. (NERA), an economic consulting firm specializing in microeconomic analysis, including regulated industries. My business address is One Main Street, Cambridge, MA 02142. I received my A.B. degree from Dartmouth College in 1960. I received my M.A. degree in 1963 and my Ph.D. degree in 1973, both in economics, from the University of Chicago. From 1965 to 1980, I taught at several colleges. From 1980 to 1988, I was an industry economist at the Federal Communications Commission (FCC). I was Chairman of the Maine Public Utilities Commission from 1988 through the end of 1992, and Chairman of the Massachusetts Department of Public Utilities from January 1993 to October 1995. In 1992, I was President of NARUC, the national organization of state regulators. Since leaving the Massachusetts commission, I have been employed by NERA. In both of my terms as a state utility commission chairman I was extensively involved in electric utility regulation issues along with other regulatory issues, including the introduction of competition in retail electricity service, as well as in all telecommunications markets. I was also responsible for representing both commissions before the legislatures in Maine and Massachusetts on issues and legislation related to utility regulation. During my tenure as Chairman of the Maine Commission I was also Chairman of the New England Governors Conference Power Planning Committee. While I was Chairman of the Massachusetts Department of Public Utilities, that commission issued a series of orders aiming at the reform of electric utility rate regulation, including revisions to integrated resource management procedures, the introduction of incentive regulation, and the design of electric industry restructuring for Massachusetts. As part of my work with NERA, I have monitored restructuring efforts at the state and federal levels, as well as internationally. I have worked at NERA on projects related to electric restructuring for several utility clients

1 in several different states, including Texas, Illinois, New Jersey, and Maine. I have recently
2 served as an independent expert on restructuring for the Indiana state legislature.

3 **II. PURPOSE OF TESTIMONY**

4 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

5 A. I have been invited to testify before the Arizona Corporation Commission (ACC) by
6 Tucson Electric Power Company (TEP). The purpose of my testimony is to address the
7 economic efficiency, equity, and public policy concerns raised by some of the nine specific
8 stranded cost questions listed by the ACC for consideration at its evidentiary hearing on
9 generic issues related to stranded costs.

10 **III. BACKGROUND**

11 Q. WHAT IS YOUR UNDERSTANDING OF WHY COMPETITION IS BEING
12 INTRODUCED INTO THE ELECTRIC INDUSTRY, AND HOW IS THAT
13 UNDERSTANDING RELATED TO THE WAY IN WHICH STRANDABLE COSTS
14 SHOULD BE RECOGNIZED BY POLICYMAKERS?

15 A. Fundamental technological and economic forces are at work moving policymakers to open
16 the electric industry to competition. As a consequence, many states, including Arizona,
17 have taken active steps toward extending competition beyond the wholesale markets into
18 retail electricity sales. In many states, high electricity prices that occurred under the aegis
19 of traditional regulatory mechanisms have provided a powerful stimulus to action, but, more
20 recently, even a number of low cost states have begun investigating the benefits of opening
21 retail electricity markets to competition.

22 Looking at it from a broader intellectual context, there can be little doubt that the impact
23 of recent changes in electricity generation on attitudes toward retail competition is
24 substantially augmented by recent experience with competition and regulatory reform in
25 industries such as telecommunications, gas, airlines, and the other transportation industries.
26 In virtually every case where regulation has been criticized and where proposals have been

1 made to introduce substantial competition, some experts have said it couldn't be done. The
2 industries involved have initially argued that competition cannot work and that traditional
3 regulation should be continued. But, where competition has been introduced, the result has
4 invariably been an improvement in overall consumer welfare.¹ The cumulative effect of
5 this has been a renewal of interest over the last two decades in relying on markets and
6 market-like tools in place of "command and control" regulation. Although the complexity
7 of the production and distribution process in the electric power industry provides reasons to
8 be careful as we proceed, it is unlikely that electricity will be an exception to the general
9 rule that market forces produce better outcomes than regulatory structures.

10 The demand for competitive options has also been stimulated by recent conditions in
11 wholesale electricity markets in many parts of the United States. Customers are aware that
12 the (wholesale) market prices at which bulk power trades between utilities and their
13 suppliers, especially in the short run, bear little relation to the prices (usually based on
14 embedded costs) that they themselves pay for electricity. This is partly a result of the fact
15 that there is (or has been) excess capacity for the production of electricity in many parts of
16 the country. But, more fundamentally, and of greater significance for the long-term, larger
17 customers are aware that electricity can be produced over the longer term at lower costs
18 than today's prices by actually building new, more efficient, capacity. Even in the absence
19 of excess capacity, today's power plants can produce electricity on a going-forward basis at
20 costs lower than historic cost levels. Particularly because of this last factor, policy makers
21 at all levels have recognized that real, long-term savings are possible and are paying more
22 attention to the cost of providing reliable electric power. It is these types of gains that
23 should be pursued in order to benefit society as a whole – not shifts that allow an advantage
24 to one group of ratepayers at expense of another, and not transitory wealth transfers that
25 arbitrarily make shareholders worse off in order to benefit ratepayers. If care is not taken in

¹ See Crandall and Ellig, Economic Deregulation and Customer Choice: Lessons for the Electric Industry, Center for Market Processes, n.d.

1 addressing the stranded cost problem during the transition, the introduction of competition
2 could actually raise, rather than reduce, the overall costs of producing electricity.

3 To be more explicit, it is clear that the societal benefits of competition are too often
4 misunderstood. Producing real benefits of competition involves more than simply lowering
5 prices in the short-term. Rather, real and sustainable lower prices will be the result of a
6 properly-structured competition policy that impels all firms to better performance.
7 Genuine, long-term benefits will come only from greater operating efficiency, innovative
8 product offerings and pricing alternatives, and greater efficiency in major supply investment
9 decisions. That is, only real improvements in efficiency can benefit all consumers, over
10 time, as a group.

11 Lower prices that arise only because the buyer has found a way to avoid paying the
12 costs embedded in current rates must be distinguished from the real savings I have
13 discussed above. It is quite possible that a competitor could supply electricity at a price
14 below current rates, yet above the going-forward (economic) cost of service. In such a case,
15 the ability to circumvent the recovery of embedded costs (or, alternatively, to “strand” these
16 costs) would actually increase the real costs of society’s electric supply. Properly designed
17 stranded cost recovery mechanisms, as discussed below in my testimony, can avoid this
18 problem while still permitting efficient competition and affording incumbent utilities a
19 reasonable opportunity to recover their past investments.

20 As competitive alternatives expand, benefits come also as utilities are released from the
21 obligation to serve. This, in turn, both allows and compels competing firms to select energy
22 supply alternatives that—in their own judgment—promise to minimize long-run total cost,
23 and customers are relieved of the expectation that they will pay all prudently incurred cost,
24 regardless of whether or not the supply choices result in the most economic outcome.
25 Critically, the risks of inappropriate investments or actions are shifted to the firms that are
26 providing service. In short, under competition utilities will begin to operate on a true
27 market basis like other businesses do.

1 While real and potentially significant, these benefits are prospective in nature – they
2 cannot be simply legislated or ordered overnight. Because real improvements in efficiency
3 are only achieved over time, as new investments are made and operating procedures are
4 revised, savings from these factors are unlikely by themselves to enable significant rate
5 reductions in the short term. It is also inappropriate to classify rate reductions that are only
6 achievable as a result of depriving utilities of the reasonable opportunity to recover costs
7 prudently incurred in order to meet the historic obligation to serve as a benefit of
8 competition. The political challenge, however, is that policy makers are under pressure to
9 deliver short-term benefits, e.g., immediate rate reductions, while the bulk of the real
10 economic benefits of competition will be slower in coming.

11 **IV. THE ACC'S NINE STRANDED COST QUESTIONS**

12 **Q. WHAT ARE THE ACC'S NINE SPECIFIC STRANDED COST QUESTIONS?**

13 **A. They are as follows:**

- 14 1. Should the Electric Competition Rules be modified regarding stranded costs, if so, how?
- 15 2. When should "Affected Utilities" be required to make a "stranded cost" filing pursuant
16 to A.A.C. R14-2-1607?
- 17 3. What costs should be included as part of "stranded costs" and how should those costs be
18 calculated?
- 19 4. Should there be a limitation on the time frame over which "stranded costs" are
20 calculated?
- 21 5. Should there be a limitation on the recovery time frame for "stranded costs"?
- 22 6. How and who should pay for "stranded costs" and who, if anyone, should be excluded
23 from paying for stranded costs?
- 24 7. Should there be a true-up mechanism and, if so, how would it operate?
- 25 8. Should there be price caps or a rate freeze imposed as part of the development of a
26 stranded cost recovery program and if so, how should it be calculated?
- 27 9. What factors should be considered for "mitigation" of stranded costs?

1 **A. Question Number 1**

2 Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 1: "SHOULD THE
3 ELECTRIC COMPETITION RULES BE MODIFIED REGARDING STRANDED
4 COSTS, IF SO, HOW?"

5 A. I have reviewed the ACC's Electric Competition Rules as they relate to stranded costs and
6 find them to be a reasonable set of principles and general mechanisms for how stranded
7 costs should be dealt with in the beginning phases of the transition to competition. In terms
8 of actual implementation requirements, however, much additional work has to be done to
9 fill in the details. There is one particular part of the Rules that I would recommend be
10 modified. In R14-2-1607(A), the ACC suggests that utilities' profits from a "wider scope
11 of services" should be used to mitigate stranded costs. As long as the wider scope of
12 services is intended to include only those tariffed services offered by the utility itself, and
13 not unregulated services offered by affiliates of the utility, then I think it is a reasonable
14 requirement.

15 It is generally accepted that utilities should not be allowed to recover the costs of
16 unregulated affiliated ventures from monopoly ratepayers; otherwise, ratepayers would be
17 subsidizing the competitive venture. This would obviously harm both monopoly ratepayers
18 and adversely affect competition in the subsidized sector. The flip side of this requirement
19 is that regulators should not seek to capture the benefits of competitive ventures for
20 ratepayers. To do so leads to a set of problems that are similar and equally inefficient.
21 Investment incentives will be attenuated for the utility in the competitive sector, while
22 prices for regulated services will be artificially reduced, with corresponding adverse effects
23 on both competition and investment in that sector. As long as ratepayers are protected from
24 being harmed by affiliate interests (as they should), they should not expect to capture the
25 benefits of those ventures – even for the mitigation of stranded costs.

26 Q. WHAT IS YOUR OPINION ON THE ACC'S CONCLUSION THAT UTILITIES
27 SHOULD BE ALLOWED AN OPPORTUNITY TO RECOVER STRANDED COSTS?

1 A. Certainly, the ACC should not modify its fundamental conclusion that it “shall allow
2 recovery of unmitigated Stranded Cost by Affected Utilities” (R14-2-1607(B)).

3 Q. PLEASE EXPLAIN WHY YOU BELIEVE THAT UTILITIES SHOULD BE ALLOWED
4 RECOVERY OF STRANDED COSTS?

5 A. Arizona utilities have made investments over the years to satisfy their legal obligation to
6 provide adequate and reliable service to each and every customer who desired electricity
7 and was within the utilities’ service territory. The costs associated with earning a fair return
8 of and on these investments have formed the basis for setting the capital cost portion of the
9 utility’s rates. Other rate-setting factors unique to the regulated environment, and that
10 differentially impact utilities compared to other industries, are the mandated use of long
11 depreciation schedules, the creation of “regulatory assets” based on the promised future
12 recovery of these assets, and mandatory social program expenditures (such as low income
13 and environmental programs). For reasons that have been exhaustively described
14 elsewhere,² some of these legitimately-incurred investments could become “stranded,” i.e.,
15 unrecoverable, in the transition to a competitive marketplace.

16 The question then becomes whether and how the utility should be allowed to recover—
17 in some approved manner that is consistent with the policy determination to rely on
18 competition—the gap between its embedded cost-based rates and the lower prevailing
19 market rates. That gap is referred to as stranded costs, i.e., costs prudently incurred under
20 traditional regulation that the utility would be unable to recover in a competitive generation
21 market. Unless special provision is made by legislators and/or regulators, shareholders may
22 not recover fully the funds they provided the company in good faith while the old system
23 was in effect. In my opinion, public policies aimed at introducing competition into
24 electricity markets will proceed more quickly, cooperatively, and ultimately successfully if
25 utilities are given a fair opportunity to recover these costs.

² See William J. Baumol, Paul L. Joskow and Alfred E. Kahn. “The Challenge for Federal and State Regulators: Transition from Regulation to Efficient Competition in Electric Power,” Edison Electric Institute, December 9, 1994.

1 Q. PLEASE EXPLAIN.

2 A. The risk associated with investments is treated much differently in regulated and
3 unregulated industries, but, in both cases, a symmetry exists between risk and the
4 distribution of rewards. This symmetry can be described as the principle: "reward follows
5 risk." In unregulated markets, investors are faced with the full cost of investments that are
6 unsuccessful, but they are allowed to keep all of the profits derived from good investments.
7 Under traditional forms of regulation (i.e., rate-of-return, cost-plus regulation), ratepayers
8 face the risk of investment once it is approved as prudent by regulators and included in the
9 rate base. If the investment turns out to be successful, the company's shareholders are
10 allowed to earn no more than the cost of capital in return, which means in effect that
11 ratepayers receive the cost savings or similar benefits of the good investment. On the other
12 hand, if the investment turns out to be unsuccessful, shareholders are not penalized –
13 ratepayers remain responsible for covering its costs. In return for accepting this investment
14 risk, ratepayers benefit from capital costs that may be lower than they otherwise would be if
15 shareholders faced that risk (all else being equal). The important point is that there is
16 symmetry between risks and rewards in both regulated and unregulated markets.

17 In terms of the current debate, denying utilities an opportunity to recover their stranded
18 costs would upset the symmetry that lies at the heart of traditional forms of regulation. It
19 would be a case of the regulators saying to the shareholders – heads-we-win, tails-you-lose.
20 If private investors – on whose capital we rely to provide necessary services in a market
21 economy – are unable to rely on the government to keep its commitments and not act
22 opportunistically, then they would demand a much higher return on their investments to
23 compensate them for the increased uncertainty. The fact is that utility investors have not
24 been compensated for the risk that regulators would upset the "risk/reward" symmetry of
25 traditional regulation as part of a policy transition to open markets to competition.
26 Recognition of this fact must continue through the transition to competition. It is entirely
27 appropriate in my opinion – indeed desirable -- to change *on a going-forward basis* to a
28 framework in which the risk of prospective investments will be placed entirely on the
29 shareholders, but that does not alter the responsibility of policymakers to honor the

1 symmetry of the previous regulatory framework on investments that were already made and
2 approved for recovery in rates.

3 Q. DID YOU ACT CONSISTENT WITH THIS BELIEF WHEN YOU WERE A
4 REGULATOR?

5 A. Yes. When I was Chairman of the Massachusetts Department of Public Utilities, that
6 commission began the process of introducing retail electric competition to the state. We
7 issued an order laying out principles for the transition, among other things. On stranded
8 costs, we found:

9 Utilities should have a reasonable opportunity to recover net, non-mitigatable,
10 stranded costs associated with commitments previously incurred pursuant to
11 their legal obligations to provide electric service. D.P.U. 95-30, p. 28 (1995).

12 The Federal Energy Regulatory Commission (FERC), in its Order 888, similarly
13 affirmed...

14 ...our preliminary determination that the recovery of legitimate, prudent and
15 verifiable stranded costs should be allowed...We will not ignore the effects of
16 recent significant statutory and regulatory changes on the past investment
17 decisions of utilities. While, as some commenters point out, there has always
18 been some risk that a utility would lose a particular customer, in the past that
19 risk was smaller. It was not unreasonable for the utility to plan to continue
20 serving the needs of its wholesale requirements customers and retail customers,
21 and for those customers to expect the utility to plan to meet future customer
22 needs. With the new open access, the risk of losing a customer is radically
23 increased.³

24 In addition, I should point out that while I was Chairman of both the Maine and
25 Massachusetts commissions, great care and much time was spent in rate cases determining
26 which investments would be approved as prudent and thus allowed into rate base. These
27 were some of the most hotly contested issues that the commissions dealt with. The reason

³ *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Federal Energy Regulatory Commission, Docket Nos. RM95-8-000 and RM94-7-001, Order No. 888 Final Rule, issued April 24, 1996.

1 why the issue of prudence was so important was that we understood that once an investment
2 is approved for inclusion in rate base, we had an obligation to allow the utility to recover
3 and earn a return on that investment. If the commitment had not been there, I can assure
4 you that the question of prudence would not have been as crucial an issue as the parties and
5 the regulators made it.⁴

6 I also have reviewed the relevant parts of the ACC decision on the prudence of TEP's
7 expenses related to the Springerville generating facility (Docket No. U-1933-88-090,
8 Decision No. 56659, October 24, 1989, pp. 7-12). The thoroughness of that review in
9 approving recovery of those expenses in part and disallowing recovery in part because of
10 what the ACC found to be TEP's imprudence suggests to me that the ACC understood that
11 its decision was of great importance because it determined how much Springerville-related
12 costs TEP would be entitled to an opportunity to recover.

13 B. Question Number 2

14 Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 2: "WHEN SHOULD
15 "AFFECTED UTILITIES" BE REQUIRED TO MAKE A "STRANDED COST" FILING
16 PURSUANT TO A.A.C. R14-2-1607?"

17 A. R14-2-1607(G) states that utilities "shall file estimates of unmitigated Stranded Cost. Such
18 estimates shall be fully supported by analyses and by records of market transactions
19 undertaken by willing buyers and willing sellers." These filings should be required a
20 reasonable period of time after the ACC issues its decision in this case, but prior to the
21 introduction of retail customer choice in order to provide some indication for utilities,
22 alternative suppliers, and customers of just how much (and in what manner) they will be
23 paying for recovery of stranded costs. My experience has been that uncertainty about
24 stranded cost recovery is one of the primary points that can cause delays in the movement to

⁴ Prof. Alfred Kahn asks, "If there was no previous understanding [about the commitment to recovery of approved investments], what was the point of all those rate cases in which contending parties expended great amounts of energy and dollars arguing about the dimensions of the costs properly recoverable in rates?" Alfred E. Kahn, "Thirteen Steps to Reconciliation," Regulation, 1996 Number 4, p. 14.

1 competition. Therefore, providing commitments to recovery, establishing estimates for
2 total stranded costs (even if rough and subject to later revisions), and determining the
3 mechanism for recovery are all important steps for regulators to take prior to the
4 introduction of retail choice.

5 **C. Question Number 3**

6 Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 3: "WHAT COSTS SHOULD
7 BE INCLUDED AS PART OF "STRANDED COSTS" AND HOW SHOULD THOSE
8 COSTS BE CALCULATED?"

9 A. All of the utility's prudently-incurred costs that would have been recovered but for the
10 policy decision to introduce retail choice should be included as part of stranded costs. This
11 includes all of the cost items listed in the ACC Staff's Stranded Cost Report, as well as
12 unrecorded regulatory assets. Stranded costs -- to the extent possible -- should be calculated
13 using information and data provided through market transactions, in order to derive the
14 difference between revenue streams that occur in the competitive market and those that
15 would have occurred under traditional regulation, rather than administrative projections and
16 estimates. It is market transactions that actually "strand" these costs, so market transactions
17 provided the most accurate information about the exact amount of stranded costs.
18 Administrative determinations are predictions about future events, and, no matter how well
19 thought out those predictions will be, they are still likely to be inaccurate.

20 I understand that TEP supports what has been called in Arizona the "net revenues lost"
21 approach, whereby stranded costs are calculated as the net present value of the difference
22 between revenues under traditional regulation and those that will be received under a
23 competitive market. Under this approach, the amount of stranded costs recovered in rates
24 adjusts along with market prices, so that only those costs that are actually being stranded are
25 being recovered at any point in time. I believe that the "net revenues lost" approach (which
26 has been called the "net-back pricing" or "lost margins" approach in other jurisdictions) is
27 an appropriate way to calculate stranded costs on a going forward basis.

D. Question Number 4

Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 4: "SHOULD THERE BE A LIMITATION ON THE TIME FRAME OVER WHICH "STRANDED COSTS" ARE CALCULATED?"

A. No. Most of the costs that should be included in the definition of stranded costs were incurred in the past (e.g., regulatory assets, unamortized and unrecoverable investment, etc.), but other costs, such as expenses related to social programs and environmental mandates, are on-going and should not be disregarded. Continuing (or any newly-imposed) regulatory requirements for investment should be included. But otherwise, assuming that the utilities' generation services no longer will be regulated on a cost-of-service basis, investments made after the date of retail access (with the exception of those made pursuant to regulatory requirements) should not be included in the calculation of stranded costs.

E. Question Number 5

Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 5: "SHOULD THERE BE A LIMITATION ON THE RECOVERY TIME FRAME FOR "STRANDED COSTS?"

A. The answer to this question is linked to my answer to Question Number 8. The recovery time frame for stranded costs depends heavily on whether or not policymakers feel the need to provide a rate cap as part of the movement to retail choice. One thing is for certain, however: the time period over which recovery takes place should not be used as a tactic to deny utilities the opportunity to recover all of their stranded costs. When you begin with the principle that there should be a reasonable opportunity to recover all stranded costs, as the ACC's Electric Competition Rules appear to do, the time frame becomes in large measure a function of other goals with regard to rate levels. For example, from a purely economic perspective, it is probably desirable to have stranded costs recovered over as short a time period as possible, in order to more quickly move to a market situation where buyers are presented with prices that reflect only marginal costs, unencumbered by regulatory legacies. However, taken too literally, this approach could result in significant short-term rate increases, and (as I have seen first-hand as a regulator, particularly in terms of the

1 telephone industry), it could be quite counterproductive for policymakers to raise
2 customers' rates in order for those customers to later on "benefit" from competition.
3 Political considerations have to be taken into account alongside economic ones, particularly
4 when a significant policy change is being made, as is the case here. To the extent that
5 short-term rate certainty is a policy goal on par with that of introducing competition, it may
6 be necessary to extend the period of stranded cost recovery.

7 It is important to recall here, as I stated at the outset of my testimony, that the real gains
8 from competition will accrue only as efficiency improves in the long-term. The only way to
9 achieve a substantial "quick fix" on rates during the transition is to either forego stranded
10 cost recovery, which, as I discussed above, is bad policy; or to extend the period of recovery
11 well into the future. Nevertheless, it may be necessary to cap current rates – keeping in
12 mind that by doing so, the recovery period for stranded costs must be lengthened to
13 compensate for the short-term consideration. This type of trade-off represents a borrowing
14 against future benefits, but could be judged necessary to build a consensus in favor of
15 restructuring the industry.

16 F. Question Number 6

17 Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 6: "HOW AND WHO
18 SHOULD PAY FOR "STRANDED COSTS" AND WHO, IF ANYONE, SHOULD BE
19 EXCLUDED FROM PAYING FOR STRANDED COSTS?"

20 A. No customer for whom the utility had an obligation to provide service should be exempted
21 from paying for stranded costs – for reasons of efficiency, as well as fairness. In terms of
22 fairness, customers with near-term competitive alternatives should not be allowed to bypass
23 recovery of investments that were made on their behalf, leaving the remaining core
24 customers with the responsibility to pay the total costs of those investments. From a public
25 policy perspective, the ACC should be careful not to release any group from all or a portion
26 of the responsibility for stranded costs, lest that increase the burden on other customers or
27 make it more difficult to provide a reasonable opportunity to recover stranded costs. This is
28 especially important at this stage of the transition, when so many major issues are as yet

1 unresolved. If the ACC were to provide select customers with special stranded cost
2 recovery treatment unavailable to other customers, it runs the risk of creating a loophole
3 that could make it more difficult to build consensus for introducing competition.

4 In terms of efficiency, selection of some for exemption from cost responsibility means
5 that the burgeoning competitive market will be distorted, because customers who are not
6 required to pay for recovery of stranded costs could be making decisions based on the
7 avoidance of legitimate costs, *i.e.*, uneconomic bypass, not on the basis of going-forward
8 efficiencies of the alternatives. Inefficient competition and inefficient investment decisions
9 can result when customers considering alternative sources of energy evaluate such
10 alternatives against the current regulated price of the energy and capacity that would be
11 displaced. This is because all previously incurred costs, not just marginal costs, are
12 included in the regulated price. Hence, if the customer's current rate, based on historic
13 costs, is 5¢/kWh for generation and the market value of generation that would be displaced
14 by an alternative is 3¢/kWh, an efficient investment decision by the customer would be
15 expected if the customer would see a savings of at least 2¢/kWh off its current rate if
16 alternatives are used. If the customer saw a savings of less than 2¢/kWh, an inefficient
17 investment decision—often referred to as uneconomic bypass—would occur. Alternative
18 energy sources that are more expensive than the marginal costs could proliferate. Assessing
19 stranded cost recovery on a non-discriminatory basis, on the other hand, would be expected
20 to encourage the efficient investment result—*i.e.*, generation alternatives that are lower in
21 cost than market prices will have an incentive to be used and generation alternatives that are
22 not competitive with market prices will not be used. Hence, from an economic efficiency
23 perspective it is clear that assessing all customers, whomever their supplier may be, with
24 stranded cost charges—*i.e.*, charges that reflect back to the customer the above market
25 portion of the utility's past generation costs—should encourage an economically efficient
26 result by providing the right price signals. Arguments that such a policy would produce
27 economically inefficient results or would preclude efficient competition are clearly wrong.

G. Question Number 7

1
2 Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 7: "SHOULD THERE BE A
3 TRUE-UP MECHANISM AND, IF SO, HOW WOULD IT OPERATE?"

4 A. Because the amount of costs that are stranded changes with a number of variables (e.g.,
5 market price), stranded cost recovery can be adjusted periodically according to what
6 actually happens with these variables. The necessity for a true-up mechanism depends on
7 which method for calculating and recovering stranded costs is chosen. For example, the
8 "net revenues lost" approach automatically re-sets stranded cost recovery in response to
9 actual market conditions. The amount that customers are required to pay goes up or down
10 depending on what happens with market prices. An administrative determination and
11 estimate of stranded costs may require some sort of true-up due to the uncertain nature of
12 estimates. Care should be taken, however, that periodic true-ups do not become, in effect, a
13 reconciliation mechanism that constantly adjusts stranded cost recovery not only to market
14 prices but to changes in embedded costs. That type of reconciliation mechanism would
15 create a "cost-plus" environment that would attenuate incentives for efficiency and stranded
16 cost mitigation. Certain other approaches, such as a utility's decision to divest its
17 generation assets, would of course not require a true-up, because utility investors will be
18 faced with the going-forward risk that the one-time fixed amount paid in a market
19 transaction for the assets will be an accurate reflection of value.

20 **H. Question Number 8**

21 Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 8: "SHOULD THERE BE
22 PRICE CAPS OR A RATE FREEZE IMPOSED AS PART OF THE DEVELOPMENT OF
23 A STRANDED COST RECOVERY PROGRAM AND IF SO, HOW SHOULD IT BE
24 CALCULATED?"

25 A. I assume that "price cap" in this context refers to a requirement that prices cannot exceed
26 current levels, and is not intended to mean a price cap form of performance-based
27 regulation: The latter can be an appropriate and desirable way to mitigate stranded costs. I
28 don't know whether there should or should not be price caps or a rate freeze. As noted

1 earlier in my response to Question 5, that is a political question, not an economic one.
2 However, I would like to offer an observation that the overarching policy goal in this
3 process should be a commitment to the introduction of retail choice, and, if a price cap or
4 rate freeze is necessary to build consensus in favor of competition, then the ACC may
5 decide it is necessary to include it, even though it could mean a longer period for recovery
6 of stranded costs.

7 **I. Question Number 9**

8 Q. WHAT IS YOUR RESPONSE TO QUESTION NUMBER 9: "WHAT FACTORS
9 SHOULD BE CONSIDERED FOR "MITIGATION" OF STRANDED COSTS?"

10 A. Any potential cost savings related to what would normally be considered as part of the
11 utility's cost of service should be considered for mitigation of stranded costs. What should
12 not be considered is revenue from non-utility operations, such as holding company
13 investments. Some critics of stranded cost recovery suggest that the utility and its holding
14 company do not have a legitimate claim for stranded cost recovery when they are making
15 unregulated investments in other industries or internationally. These critics sometimes also
16 suggest that earnings from these non-utility investments should be used to write-down
17 stranded costs. Investments in non-utility operations are funded either from non-utility-
18 related sources or from the shareholders' legitimate earnings. Utility shareholders are
19 entitled to earn a return of and on prudently-invested capital, but what they then do with
20 their return really should not be a concern of regulators. In fact, if regulators decide to
21 garner the rewards of such investments, then shareholders also should be compensated
22 when those non-utility investments turn out poorly. Needless to say, I am not
23 recommending such an approach. To put it bluntly, the problem of stranded costs exists
24 because traditional regulatory practices put the risk of investment on the backs of ratepayers
25 – the solution to the problem should not repeat this error with non-utility investments.

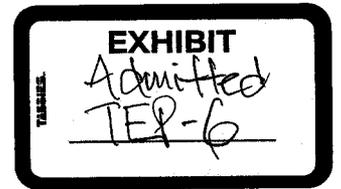
26 One good potential source of mitigation is savings related to adoption of performance-
27 based regulation. Economists have long criticized the "cost-plus" nature of traditional rate-
28 of-return regulation because of the disincentives it creates for efficient operations and use of

1 capital. Many regulatory agencies have replaced traditional regulation with performance-
2 based regulation, such as banded returns and price caps, particularly for telecommunications
3 companies. The cost savings that result from such plans can be used to mitigate stranded
4 cost recovery.

5 Another legitimate source of mitigation for stranded costs can be securitization of
6 stranded costs. Securitization allows for stranded cost recovery with lower capital costs
7 because investors have less risk associated with the cost recovery. Securitization does give
8 utility shareholders a fairly certain commitment to recover the securitized amount,
9 regardless of other factors (which is why securitization results in lower capital costs), but as
10 long as policymakers recognize the commitment to an opportunity to recover stranded
11 costs, as they should, there is no reason not to use any legitimate mechanisms that can lower
12 stranded costs.

13 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

14 A. Yes.



DIRECT TESTIMONY OF KENNETH GORDON

SUMMARY

My name is Kenneth Gordon. I am Senior Vice President of National Economic Research Associates, Inc. (NERA), an economic consulting firm specializing in microeconomic analysis, including regulated industries. My business address is One Main Street, Cambridge, MA 02142. I have been invited to testify before the Arizona Corporation Commission ("ACC") by Tucson Electric Power Company ("TEP"). The purpose of my testimony is to address the economic efficiency, equity, and public policy concerns raised by some of the nine specific stranded cost questions listed by the ACC for consideration at its evidentiary hearing on generic stranded cost issues. I have reviewed the ACC's Electric Competition Rules as they relate to stranded costs and find them to be a reasonable set of principles and general mechanisms for how stranded costs should be dealt with in the beginning phases of the transition to competition. In terms of actual implementation requirements, however, much additional work has to be done to fill in the details.

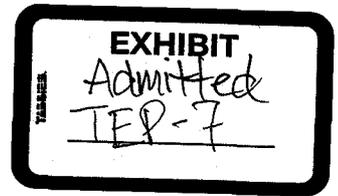
Certainly, the ACC should not modify its fundamental conclusion that it "shall allow recovery of unmitigated Stranded Cost by Affected Utilities" (R14-2-1607(B)). Arizona utilities have made investments over the years to satisfy their legal obligation to provide adequate and reliable service to each and every customer who desired electricity and was within the utilities' service territory. Some of these legitimately-incurred investments could become "stranded," *i.e.*, unrecoverable, in the transition to a competitive marketplace. Unless special provision is made by legislators and/or regulators, shareholders may not recover fully the funds they provided the company in good faith while the old system was in effect. In my opinion, public policies aimed at introducing competition into electricity markets will proceed more quickly, cooperatively, and ultimately successfully if utilities are given a fair opportunity to recover these costs.

The risk associated with investments is treated much differently in regulated and unregulated industries, but, in both cases, a symmetry exists between risk and the distribution of rewards. Denying utilities an opportunity to recover their stranded costs would upset the symmetry that lies at the heart of traditional forms of regulation. It would be a case of the regulators saying to the shareholders -- heads-we-win, tails-you-lose. The fact is that utility investors have not been compensated for the risk that regulators would upset the "risk/reward" symmetry of traditional regulation as part of a policy transition to open markets to competition. It is entirely appropriate in my opinion -- indeed desirable -- to change *on a going-forward basis* to a framework in which the risk of prospective investments will be placed entirely on the shareholders, but that does not alter the responsibility of policymakers to honor the symmetry of the previous regulatory framework on investments that were already made and approved for recovery in rates.

In my testimony, I discuss several other issues related to stranded costs and make the following recommendations:

- Stranded cost questions should be resolved prior to the introduction of retail customer choice in order to provide some indication for utilities, alternative suppliers, and customers of just how much (and in what manner) they will be paying for recovery of stranded costs. Uncertainty about stranded cost recovery is one of the primary points that can cause delays in the movement to competition.
- All of the utility's prudently-incurred costs that would have been recovered but for the policy decision to introduce retail choice should be included as part of stranded costs. This includes all of the cost items listed in the ACC Staff's Stranded Cost Report, as well as unrecorded regulatory assets.
- TEP supports the "net revenues lost" approach for calculating stranded costs, whereby stranded costs are the net present value of the difference between revenues under traditional regulation and those that will be received under a competitive market. Under this approach, the amount of stranded costs recovered in rates adjusts along with market prices, so that only those costs that are actually being stranded are being recovered at any point in time. I believe that the "net revenues lost" approach (which has been called the "net-back pricing" or "lost margins" in other jurisdictions) is an appropriate way to calculate stranded costs on a going forward basis. Utilities also should have the option of divesting all or some of their generation assets as a way to calculate stranded costs.

- The recovery time frame for stranded costs depends heavily on whether or not policymakers feel the need to provide a rate cap as part of the movement to retail choice. The time period over which recovery takes place should not be used as a tactic to deny utilities the opportunity to recover all of their stranded costs. To the extent that short-term rate certainty is a policy goal on par with that of introducing competition, it may be necessary to extend the period of stranded cost recovery. This type of trade-off represents a borrowing against future benefits, but could be judged necessary to build a consensus in favor of restructuring the industry.
- No customer for whom the utility had an obligation to provide service should be exempted from paying for stranded costs – for reasons of efficiency, as well as fairness. In terms of fairness, customers with near-term competitive alternatives should not be allowed to bypass recovery of past investments, leaving the remaining core customers to pay the total costs of those investments. In terms of efficiency, selection of some for exemption from cost responsibility can distort the competitive market, because exempted customers could be making decisions based on the avoidance of legitimate costs, *i.e.*, uneconomic bypass, not on the basis of going-forward efficiencies.
- The necessity for a true-up mechanism depends on which method for calculating and recovering stranded costs is chosen. For example, the “net revenues lost” approach automatically re-sets stranded cost recovery in response to actual market conditions. An administrative determination and estimate of stranded costs may require some sort of true-up due to the uncertain nature of estimates.
- Any potential cost savings related to what would normally be considered as part of the utility’s cost of service should be considered for mitigation of stranded costs. What should not be considered is revenues from non-utility operations, such as holding company investments. Investments in non-utility operations are funded either from non-utility-related sources or from the shareholders’ legitimate earnings. Utility shareholders are entitled to earn a return of and on prudently-invested capital, but what they then do with their return really should not be a concern of regulators.
- A good potential source of mitigation is savings related to adoption of performance-based regulation. Economists have long criticized the “cost-plus” nature of traditional rate-of-return regulation because of the disincentives it creates for efficient operations and use of capital. The cost savings that result from performance-based regulation plans can be used to mitigate stranded cost recovery.
- Another legitimate source of mitigation for stranded costs can be securitization of stranded costs. Securitization allows for stranded cost recovery with lower capital costs because investors have less risk associated with the cost recovery. As long as policymakers recognize the commitment to an opportunity to recover stranded costs, as they should, there is no reason not to use any legitimate mechanisms that can lower stranded costs.



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-00000C-94-0165
THE PROVISION OF ELECTRIC SERVICES)
THROUGHOUT THE STATE OF ARIZONA.) **REBUTTAL TESTIMONY OF**
_____) **KENNETH GORDON**

On Behalf of
TUCSON ELECTRIC POWER COMPANY

FEBRUARY 4, 1998

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1 **REBUTTAL TESTIMONY OF KENNETH GORDON**

2 **I. QUALIFICATIONS**

3 Q. PLEASE STATE YOUR NAME AND ADDRESS.

4 A. My name is Kenneth Gordon. I am Senior Vice President of National Economic Research
5 Associates, Inc. (NERA), an economic consulting firm specializing in microeconomic
6 analysis, including regulated industries. My business address is One Main Street,
7 Cambridge, MA 02142.

8 Q. ARE YOU THE SAME KENNETH GORDON WHO FILED DIRECT TESTIMONY IN
9 THIS PROCEEDING ON JANUARY 9, 1998?

10 A. Yes, I am.

11 **II. PURPOSE OF TESTIMONY**

12 Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

13 A. The purpose of my rebuttal testimony is to respond - on behalf of Tucson Electric Power
14 Company (TEP or Company) - to certain arguments and assertions made in testimony that
15 was filed on January 21, 1998 by a number of parties representing a diverse group of
16 interests.

17 **III. THE REGULATORY COMPACT**

18 Q. MANY WITNESSES OBJECT TO THE CHARACTERIZATION OF A REGULATORY
19 COMPACT PUT FORTH BY TEP WITNESSES. WHAT IS YOUR UNDERSTANDING
20 OF THE REGULATORY COMPACT?

21 A. In the context of regulated utility companies, the term "regulatory compact" is a shorthand
22 way of referring to the understanding between regulators and investors inherent in
23 traditional, rate-base, cost-of-service regulation. The essence of that understanding is that
24 regulators ensure an opportunity to recover all prudently incurred costs, in exchange for the

1 utility assuming an obligation to serve all customers who want service, at rates that cover
2 the cost of capital but do not allow the firm to earn economic profits. It does not matter
3 whether one wants to call this understanding a compact, a bargain, or a banana¹ - as long as
4 one understands that neither the regulators nor the utilities can unilaterally change the terms
5 of the bargain *as they relate to past events*. Regulators and policymakers are now and
6 always have been free to alter the terms of this understanding on a going-forward basis -
7 and I am a long-time advocate of doing so through the adoption of performance-based
8 regulation, and, even more importantly, through the introduction of competition - but it is
9 inappropriate to ignore the past or apply the substantive standards of the new, competitive
10 model to previous arrangements that were consummated under the soon-to-be discarded
11 standards of rate-base regulation.

12 Q. BUT DR. ROSE SAID THAT REGULATORS ALWAYS HAVE BEEN FREE TO
13 CHANGE THEIR METHOD OF ASSET VALUATION TO A MARKET VALUATION
14 (ROSE TESTIMONY, P. 7, LINES 5-8).

15 A. That is correct, but it does not absolve the regulator from a responsibility to deal fairly with
16 the consequences of that change and how it impacts commitments that were made under the
17 old system. Setting rates on the basis of historic costs may have been a consumer safeguard
18 in the quest to mimic the outcome of competitive markets, as Dr. Rose suggests, but if there
19 is evidence that regulators have failed in that regard, they cannot simply wash their hands of
20 past mistakes and start fresh with a new system.

21 Dr. Rose correctly identifies what the outcome of such a change in the current
22 environment would be if past commitments are not honored: it would benefit ratepayers
23 (though only in the short-term, in my opinion) and penalize stockholders (Rose Testimony,
24 p. 7, lines 1-3). However, he suggests that this outcome is fair as long as regulators do not
25 change "back and forth" (*Id.*). In other words, he's saying that it is fair to penalize

¹ "If, for whatever reason of politics, law, or aesthetics, one objects to the characterizing the implicit basis of these intensely contested [rate case] determinations as compacts or bargains, then, by good fortune, we have a
(continued...)"

1 stockholders once ... as long as you don't do it again. I submit that making a regulatory
2 policy change without compensation for the consequences of that change is the very essence
3 of government opportunism. I agree with Dr. Rose that the intent of electric restructuring is
4 to improve the incentives to minimize costs (Id., lines 3-5), but this change only takes effect
5 on a going-forward basis and cannot be used as a mechanism for changing the nature of past
6 commitments or expressing a wish that different decisions had been made in the past. Only
7 in the future can the benefits of competition be realized.

8 Changing the rules of the game and then applying them to what happened in the past
9 would be like doing away with the 3-point shot in basketball and then adjusting all of the
10 scores and outcomes of last year's games by subtracting a point for every shot that counted
11 for three points under last year's rules. Rules and standards can be changed at a point in
12 time, but they cannot be applied to the past. This policy requirement is similar in principle
13 to the prohibition against the government passing laws that prohibit something and then
14 prosecuting you for doing it before the law was passed.

15 Q. YOU SAID THAT UTILITY INVESTORS ARE GUARANTEED TO AN
16 OPPORTUNITY TO EARN A COMPETITIVE RETURN. IS THIS THE SAME AS
17 GIVING UTILITIES A GUARANTEE OF STRANDED COST RECOVERY?

18 A. Not at all. My testimony is that utility investors should be guaranteed a reasonable
19 opportunity to recover 100% of their stranded costs - not that they should be guaranteed
20 recovery of 100% of stranded costs. "Reasonable" not only means that the utility will have
21 to expend solid management effort in order to achieve its goal, but also that the standard
22 does not represent an impossible hurdle. This is the same judgment that regulators have had
23 to bring to bear since the beginning of regulation. Several witnesses mischaracterize TEP's
24 testimony in this respect. Utilities have never had a guarantee that they will recover all of
25 their costs, even those costs that the regulator expressly approves for recovery in rates. The

(...continued)

historical precedent for an alternative appellation – let us call it a banana.” Alfred E. Kahn, “Thirteen Steps to Reconciliation,” *Regulation*, 1996 Number 4, p. 14.

1 opportunity to recover those costs has been subject to rate case evaluations of company
2 productivity, filing requirements, and changes in supply and demand conditions and
3 technology that occur independent of government actions. This should not change with the
4 introduction of competition.

5 Q. WHAT DO YOU MEAN BY “CHANGES IN SUPPLY AND DEMAND CONDITIONS
6 AND TECHNOLOGY THAT OCCUR INDEPENDENT OF GOVERNMENT
7 ACTIONS”?

8 A. This is an important distinction. Several witnesses have suggested that allowing an
9 opportunity for stranded cost recovery is extraordinary because utilities were always at
10 some degree of risk from changes in supply and demand conditions and technology. That is
11 true so far as it goes, but it does not address the central question related to stranded costs
12 and customer choice - that is, whether utility investors were at risk from changes in supply
13 and demand conditions and technology that would have had no effect on cost recovery
14 *absent government actions*. It is undeniable that the introduction of competition, which, as
15 several witnesses point out is what actually strands costs, occurs only as a result of
16 fundamental, and until very recently, unanticipated, shifts in government policy toward the
17 electricity industry.

18 In addition, it is well worth noting that policymakers in other industries have either
19 provided for stranded cost recovery or are planning to open investigations to explore the
20 issue - further evidence that such recovery is not “extraordinary.” For example, consider
21 the dramatic success achieved by the FERC in restructuring the gas industry through orders
22 such as 436 and 636. It is generally recognized that this success was made possible largely
23 because the FERC decided - after five years of struggling in legal and regulatory
24 proceedings with the issue of stranded costs - to allow pipelines the opportunity to recover
25 100% of their stranded costs. In addition, as I noted in my direct testimony, the FERC has
26 recognized the legitimacy of electric utility stranded cost claims, at least as they apply to

1 wholesale markets.² As Professor Richard J. Pierce, Jr. has observed, before a workable
2 solution to the stranded cost problem was achieved “the reluctance of regulatees to absorb
3 transition costs, combined with the sympathetic response of judges to the plight of FERC’s
4 regulatees, posed a major threat to the viability of any FERC attempt to implement a major
5 change in policy.”³

6 In the telephone industry, the Federal Communications Commission has stated in its
7 recent Access Charge Reform order its intention to issue a separate order that

8 will....address ‘historical cost’ recovery: whether and to what extent carriers
9 should receive compensation for the recovery of the allocated costs of past
10 investments if competitive market conditions prevent them from recovering such
11 costs in their charges for interstate access services. (Access Charge Reform First
12 Report and Order, par. 14).

13 Q. SEVERAL WITNESSES POINT OUT THAT STRANDED COST RECOVERY IS NOT
14 CONSISTENT WITH THE COMPETITIVE MODEL. DO YOU AGREE?

15 A. Yes, but regulation generally has not been applied in a manner consistent with the economic
16 principles of a competitive market model. For example, as I noted in my direct testimony,
17 shareholders bear all of the risk and recoup all of the rewards associated with their
18 investments in unregulated competitive markets. That is clearly not the case under
19 traditional forms of regulation, and it is one of the benefits of moving to competition and/or
20 incentive regulation that such a policy change *prospectively* will alter - hopefully, once and
21 for all - the risk/reward relationship to make it closer to the competitive model. Also,
22 competitive market prices are determined according to incremental or reproduction costs,
23 and, while regulators have always had the option of setting rates based on reproduction
24 costs, they have generally used historic costs as reported in a test year at least in part as the
25 basis for rate-setting. In this respect, I do not see how Dr. Cooper can contend that utilities

² Direct Testimony of Kenneth Gordon, p. 9, lines 14-23, citing to: *Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities*, Federal Energy Regulatory Commission, Docket Nos. RM95-8-000 and RM94-7-001, Order No. 888 Final Rule, issued April 24, 1996.

³ “The State of the Transition to Competitive Markets in Natural Gas and Electricity,” April 1994, page 4.

1 “never should have anticipated earning more than a fair return on their efficient forward-
2 looking costs” (Cooper Testimony, p. 13, lines 14-15). What he is saying in effect is that
3 the reasonableness of utility rates should be judged by regulators according to how they
4 compare with reproduction costs, even though those same regulators established the same
5 rates at least in part according to historic costs. The point is that while conceptually more
6 than one approach to valuation can be used, each must be applied in an internally consistent
7 manner.

8 While it is appropriate to adopt competitive markets as the proper policy goal wherever
9 competition is feasible, it is not appropriate to judge utility claims that flow from
10 commitments made under the regulatory model according to how those claims compare to
11 what utilities should expect under the competitive model. I agree with all of the efficiency
12 benefits described by other witnesses as the benefits of competition, and that is why I
13 pursued a competitive market agenda as a regulator – for the telecommunications industry,
14 as well as electric and gas. Competition in electric generation will deliver significant
15 benefits to customers over the long-run, even while customers pay for recovery of the
16 utilities’ stranded costs. The forward-looking costs of generation under competition will be
17 lower than they would have been under regulation, and properly designed stranded cost
18 recovery will not affect the way in which competition drives forward-looking costs and
19 generation prices.

20 Q. SEVERAL WITNESSES ADVOCATE THAT STRANDED COST RECOVERY BE
21 SHARED BETWEEN RATEPAYERS AND STOCKHOLDERS. DO YOU THINK
22 THAT THIS RECOMMENDATION IS REASONABLE?

23 A. No. “Sharing” of stranded cost recovery is simply a euphemism for saying that regulators
24 should not honor their commitments and should deny recovery of prudently incurred costs.
25 As I have noted, utilities are entitled to an opportunity to recover 100% of their stranded
26 costs. The only relevant questions are whether the costs associated with the strandable
27 assets were approved by the regulator for inclusion in the rate base and whether the assets
28 will be stranded due to a change in public policy. If the answers to both of these questions
29 are in the affirmative, as they are in this case, then the utility should be afforded a

1 meaningful opportunity to recover all of the costs associated with that asset. The assets in
2 question have been approved by the ACC for inclusion in TEP's rate base, and the assets
3 become stranded only when retail choice occurs, which will be the result of a conscious
4 policy decision to allow choice.

5 The risk associated with invested capital has been shared between ratepayers and
6 shareholders already. Shareholders are at risk that investments will not be approved by
7 regulators for recovery and they are at risk for changes in supply and demand conditions
8 and technology that occur independent of changes in policy. Ratepayers are at risk for
9 investments that were approved for recovery by regulators and that are negatively impacted
10 by a change in policy. It is this latter category that forms the basis for stranded costs, and
11 some witnesses would now have risk divided again between ratepayers and shareholders,
12 even though shareholders were not compensated for that risk.

13 It is interesting to note that Dr. Rosen, who advocates a 50/50 sharing of stranded cost
14 recovery between ratepayers and shareholders, argues that 100% of any negative stranded
15 costs should be returned to ratepayers. If ratepayers are entitled to all of the rewards
16 associated with any negative stranded costs that may arise, as I believe they are, then the
17 same reasoning leads to the conclusion that they also are responsible for the risk associated
18 with positive stranded costs.

19 I realize that proposals to share the responsibility for stranded cost recovery 50/50
20 between ratepayers and shareholders have a seemingly intuitive "split the baby" appeal to
21 them, but these proposals are not derived from a reasonable reading of the historic record
22 and the precedent established over many years of traditional ratemaking. Splitting the
23 difference is not justice when anything less than an opportunity to recover 100% of stranded
24 costs represents an abrogation of existing commitments.

25 Mr. Higgins contends that the Commission should be concerned with allocating risk
26 between ratepayers and shareholders in the transition to competition in generation (Higgins
27 Testimony, p. 7, lines 6-12). I submit that the Commission should ensure that all of the
28 going-forward risk associated with generation should be borne by shareholders (and,

1 consequently, all of the going-forward rewards as well), but that stranded cost recovery
2 represents nothing more than an accounting for past risks that ratepayers accepted under
3 traditional cost-of-service regulation. It is worth repeating again that I do not endorse the
4 regulatory compact as something that should be sustained as part of the new environment:
5 on the contrary, getting rid of the regulatory compact is one of the benefits of introducing
6 competition. But my desire to see the regulatory compact fade into history does not extend
7 to ignoring past commitments that were made under that compact.

8 Q. SOME WITNESSES ARGUE THAT UTILITY SHAREHOLDERS HAVE BEEN
9 ADEQUATELY COMPENSATED FOR THE RISK THAT STRANDED COSTS
10 WOULD NOT BE RECOVERABLE. DO YOU AGREE?

11 A. I certainly disagree in terms of my own eight-year experience as a state regulator, though I
12 have no knowledge about how risk was factored into the cost of capital determinations of
13 the ACC. In the numerous rate cases in which I participated, compensation to the
14 shareholders for the risk that a policy determination would strand prudently incurred costs
15 was not included in the allowed rate-of-return. Indeed, to the best of my recollection, it was
16 never raised or discussed. Moreover, I do not believe that utility investments are risk free -
17 as Dr. Rose claims that I assert (Rose Testimony, p. 6, lines 1-2) - and I never approved a
18 risk-free rate-of-return as a regulator, either for debt or equity, but the risk that shareholders
19 have accepted and were compensated for does not include the risk of regulators acting
20 opportunistically.

21 Q. DR. COOPER CONTENDS THAT YOUR POSITION ON STRANDED COST
22 RECOVERY IS BASED ON A FUNDAMENTAL MISCHARACTERIZATION OF RISK
23 AND REWARD UNDER REGULATION (COOPER TESTIMONY, P. 20, LINES 14-
24 15.). WHAT IS YOUR RESPONSE?

25 A. Well, I would first note that the same conclusion on stranded cost recovery has been
26 reached by the FERC, the President's Council of Economic Advisers, and most of the state
27 legislatures and utility commissions who have looked at the issue. Second, in support of his
28 contention Dr. Cooper asserts that utility rates are set based on averages and utilities can

1 earn more than their approved return in some years and less in others (Cooper Testimony, p.
2 21, lines 1-8). Frankly, I do not see how this demonstrates that there is not a risk/reward
3 symmetry in traditional regulation. He suggests that there is a structural bias in favor of
4 utilities, but he does not support this suggestion with any evidence, so it is difficult to assess
5 whether his supposition is correct.

6 Lastly, Dr. Cooper argues that symmetry is broken because regulators cannot set rates
7 retroactively to capture the above-average profits in "good" years (Id., lines 9-18). But the
8 same holds true for "bad" years - the regulator still cannot set rates retroactively to
9 compensate the utility for the results of the bad year. If anything, I believe that Dr.
10 Cooper's examples in this respect are helpful in demonstrating the risk/reward symmetry
11 inherent in the traditional approach to regulation.

12 Q. THE ACC STAFF RECOMMEND AGAINST THE USE OF SECURITIZATION AS A
13 MEANS TO MITIGATE STRANDED COSTS (COOPER TESTIMONY, PP. 24-26).
14 WOULD YOU PLEASE COMMENT ON THEIR CRITICISMS?

15 A. Certainly. Assuming the Commission does not change its conclusion that utilities should be
16 allowed an opportunity for full stranded cost recovery, securitization is simply a way to
17 convert a portion of those stranded costs into a marketable security. Because the security
18 would be irrevocable (unlike recovery in the regulatory arena, which is always subject to
19 political pressures and changes in the Commission itself), investors are likely to require a
20 smaller risk premium and thus the capital carrying costs could be lower. Lower capital
21 costs reduce the total stranded costs that customers must pay for. Dr. Cooper criticizes
22 securitization on the grounds that 1) it may result in over-recovery of stranded costs, and 2)
23 it results in a large infusion of cash to the utility, which can then use that money to restrict
24 competition.

25 With respect to his first criticism, securitization usually is restricted to less than 100%
26 of stranded costs, which allows any discrepancies to be adjusted. In fact, TEP's proposal is
27 to securitize only 75% of stranded costs. Also, even if 100% of stranded costs were to be
28 securitized, the transition charge or other stranded cost recovery mechanism can be subject

1 to a “true-up” mechanism that would prevent over-recovery. In my view, the most
2 significant factor in deciding whether or not to use securitization is whether significant cost
3 savings are likely to result.

4 In terms of Dr. Cooper’s second criticism, suffice it to say that having a source of funds
5 to “spend” anticompetitively does not mean that the utility can act anticompetitively. This
6 is simply a variant of the old – and discredited – “deep pocket” theory of predation.
7 Generally, the utility will invest securitization proceeds wherever it sees the highest
8 potential return from those proceeds. This may or may not be the generation business.
9 Moreover, with open entry a reality in generation, there is little or no likelihood of
10 recovering in the future any predatory “investments” that the firm makes. Finally, antitrust
11 laws and ACC oversight will work to ensure that the utility does not act anticompetitively
12 in the generation market.

13 Q. DR. COYLE RECOMMENDS THAT THE COMMISSION SHOULD MAINTAIN OR
14 ADOPT A “BROAD SCOPE OF REVIEW” OF THE UTILITY’S NON-REGULATED
15 BUSINESSES AND THAT IT SHOULD “CAPTURE, AS APPROPRIATE, GAINS
16 FROM NON-UTILITY ENTERPRISES” (COYLE TESTIMONY, PP. 8-9, AND 40).
17 PLEASE COMMENT ON THIS RECOMMENDATION.

18 A. The irony of Dr. Coyle’s recommendation for the Commission to have a broad scope of
19 review of the utility’s non-regulated businesses and to capture the gains from those
20 businesses is that it would extend ratepayer risk from utility operations to more risky
21 unregulated operations. As I have mentioned, one of the benefits of introducing
22 competition is to avoid future stranded cost problems by shifting risk prospectively from
23 ratepayers to shareholders. If the Commission seeks to capture gains from unregulated
24 operations, it must also cover losses in unregulated operations, and I do not think that
25 replicating the mistakes of the past is an appropriate step to take in the transition to
26 competition. The regulators’ goal in terms of affiliate relations generally is to ensure that
27 ratepayers are not cross-subsidizing competitive, unregulated ventures. It is also important
28 to ensure that the competitive ventures do not subsidize ratepayers.

1 **IV. THE IMPACT OF STRANDED COST RECOVERY ON EFFICIENT**
2 **COMPETITION**

3 Q. WILL STRANDED COST RECOVERY HARM THE OPERATION AND
4 DEVELOPMENT OF A COMPETITIVE MARKET FOR ELECTRICITY GENERATION
5 SERVICES?

6 A. No, not if it is done correctly. Stranded cost recovery can be achieved in ways that have
7 virtually no impact on efficient, going-forward competition in the generation market.
8 Indeed, avoiding deleterious effects on the new generation market is one of the most
9 important goals established by policy-makers in those states that have made significant
10 progress toward the creation of a competitive electricity market.⁴ Policy-makers in these
11 states have recognized that, whatever has happened in the past, the generation market
12 should be unhindered on a going-forward basis. Stranded cost recovery can and has been
13 designed in such a way as to allow the market to clear the price for generation. The “net
14 revenues lost” approach is one such way to accomplish this goal.

15 Q. HOW HAVE OTHER STATES ACHIEVED STRANDED COST RECOVERY
16 WITHOUT HARMING COMPETITION?

17 A. While the details of the specific stranded cost recovery mechanisms vary, they generally are
18 designed to operate independent of the generation market (*i.e.*, they are competitively
19 neutral). To date, states that have made significant progress toward implementing
20 competition in electricity have arranged for stranded costs to be recovered via some form of
21 a non-bypassable, competitively-neutral “wires” or “competitive transition” charge.⁵ In this
22 way, the utilities operations in the competitive generation market are faced with the same
23 stranded cost recovery burdens as alternatives.

⁴ These states include California, Massachusetts and Pennsylvania, as well as others.

⁵ Many of the other witnesses in this proceeding are agreed on this point. For example, “The transition charge is most effectively levied as a ‘wires’ charge on distribution service, which is where the Commission has clear jurisdiction.” (Higgins, page 30). See also Malko, page 11 and Rosen, pages 68 and 77.

1 Q. YOU HAVE SAID THAT RECOVERY OF STRANDED COSTS CAN BE ACHIEVED
2 IN A MANNER THAT WILL NOT HARM THE EFFICIENCY OF THE MARKET.
3 HAVE OTHER WITNESSES IN THIS CASE TAKEN AN OPPOSITE POSITION?

4 A. For the most part, the other witnesses seem to recognize that stranded cost recovery can be
5 arranged in a way that will not harm competition.⁶ However, Dr. Rose and Dr. Cooper have
6 asserted that allowing stranded cost recovery will harm the market in several ways.

7 Dr. Rose's assertions include:⁷

- 8 • Stranded cost recovery will form a barrier to entry for new generators;
- 9 • Stranded cost recovery will form a barrier to exit for existing utility generation plants;
- 10 • Stranded cost recovery will create a moral hazard problem regarding utility efforts to
11 mitigate stranded costs;
- 12 • Stranded costs have no bearing on uneconomic bypass;
- 13 • Stranded cost recovery will create an asymmetry of risk and reward for utility earnings;
14 and
- 15 • Stranded cost recovery will provide an unfair advantage to incumbents.

16 These assertions are unconvincing. For the most part, they are based on "straw-man"
17 arguments.

18 Q. WHAT IS THE NATURE OF DR. ROSE'S STRAW-MAN ARGUMENTS?

19 A. Dr. Rose apparently assumes that the Commission will design an inferior stranded cost
20 recovery mechanism that will not be competitively neutral (Rose Testimony, p. 9, lines 16-
21 19). He then points to the inevitable failures of that poorly designed recovery mechanism
22 and rejects recovery absolutely on the basis of the straw-man's poor performance. He gives
23 no indication that he is aware that the design of competition-neutral stranded cost recovery

⁶ For example, regarding the impact of stranded costs recovery on the effectiveness of competition, "I believe there will be no impact . . . if recovery is made through a non-bypassable wires charge." Rosen p. 78

⁷ Direct Testimony of Dr. Kenneth Rose, pp. 9-17.

1 mechanisms has been an important matter of policy in the other states that have made
2 significant progress toward implementing competition in electricity. He offers no
3 discussion of the ways that other states have dealt with these same issues. He seems to
4 believe - contrary to what can be shown with easily available evidence - that these problems
5 are unavoidable. While it is certainly possible to design a recovery mechanism that harms
6 competition, I see no reason to conclude (as Dr. Rose appears to) that Arizona will make
7 this mistake while other states have avoided it.

8 Q. PLEASE COMMENT ON DR. ROSE'S CLAIM THAT STRANDED COST RECOVERY
9 WILL CREATE "BARRIERS TO ENTRY."

10 A. The term "barriers to entry" is economics jargon for uneconomic conditions not related to
11 genuine efficiency advantages that give an unfair advantage to incumbent firms in a market.
12 They are "[f]actors which place new entrants at a cost disadvantage relative to established
13 firms within an industry."⁸ With the existence of significant barriers to entry that do not
14 arise from real economic advantages, it is possible for existing firms to charge prices that
15 are above marginal cost.

16 Q. DOES STRANDED COST RECOVERY CREATE A BARRIER TO ENTRY?

17 A. No. Stranded cost recovery would form a barrier to entry only if it were levied selectively
18 on customers of new entrants to the market, while customers of the incumbent utility were
19 allowed to escape these costs. This matter has received attention in those states that have
20 made significant progress toward competition and appears to be well understood by several
21 other witnesses in this proceeding. For example,

22 I ... believe that use of a wires charge paid by all customers of the distribution
23 utility as part of a proper unbundling of rates will solve this problem. (Footnote:
24 Thus far, all states have taken this approach.) The wires charge should be
25 applied by the local distribution company, and therefore stranded costs would be
26 allocated to all customers being served by the local distribution system. Both
27 standard offer customers and those being supplied by alternative suppliers as a

⁸ *The MIT Dictionary of Modern Economics*, 4th Edition, 1992.

1 result of competition will pay for stranded costs on an equitable basis due to a
2 wires charge. (Rosen, p. 77.)

3 Q. DR. ROSE ASSERTS THAT STRANDED COST RECOVERY CREATES A “BARRIER
4 TO EXIT” FOR INEFFICIENT PLANTS (I.E., THOSE WHOSE OPERATING COSTS
5 ARE GREATER THAN THE MARKET VALUE OF THEIR OUTPUT). PLEASE
6 COMMENT.

7 A. The term “barriers to exit” is more economics terminology that describes situations where
8 entrants to a market face significant sunk costs. Costs are “sunk” when, once committed to
9 a particular use, they cannot be converted to another use. Substantial sunk costs are
10 common to many capital-intensive industries and they can have important implications for
11 market structure. When barriers to exit (*i.e.*, sunk costs) are high, a market will not
12 experience “quick hit” entry and exit. For example, it requires a great deal of capital to
13 construct a new paper mill and once the mill is built, the capital cannot be easily converted
14 to any other use. As a result, the price of paper may rise far above short-run marginal cost
15 before manufacturers finally decide to commit the capital required to enter the market.

16 This can be contrasted with, for example, some segments of the retailing sector. Many
17 stores can quite easily change their line of merchandise in response to changing market
18 conditions. Stores that stocked their shelves with Tickle-Me-Elmo last year are likely to be
19 selling Beanie Babies this year.

20 Q. IS DR. ROSE CORRECT IN ASSERTING THAT STRANDED COST RECOVERY
21 CREATES A BARRIER TO EXIT?

22 A. No. Dr. Rose’s comments are difficult to interpret. He says,

23 Inefficient suppliers are encouraged to continue to operate inefficient plants. In
24 this way recovery of uneconomic costs acts as a barrier to exit from the market
25 when it would otherwise be economic to do so. (page 9.)

26 Dr. Rose’s use of the term “barrier to exit” bears no resemblance to the use of the term in
27 mainstream economic literature. To a large degree, *all* entrants into the electric generation
28 market will face significant barriers to entry and exit because they will be required to make

1 large sunk cost investments in order to enter. In the event they cannot operate these plants
2 at a profit, they will not be able to easily recover their capital or to convert it to alternative
3 uses. For practical purposes, capital invested in the electricity industry will remain there,
4 whether or not the investment proves to be profitable.

5 Barriers to exit have no bearing on the issue of stranded cost recovery, except perhaps to
6 offer support for the argument that given regulatory requirements to price at marginal cost,
7 utilities would not have undertaken large sunk-cost investments in anticipation of demand
8 growth if they did not believe there was a contract or compact of some sort which protected
9 their capital. By contrast, investors build paper mills because they know they will be able
10 to charge very high prices when there are shortages of paper in the market. If the
11 government were to impose regulations forbidding paper manufacturers from earning
12 “excessive” profits, we might find that no new paper mills would be built—unless the
13 government also saddled paper manufacturers with an “obligation to serve.”

14 A second confusing point in Dr. Rose’s statement is his assertion that allowing an
15 opportunity for stranded cost recovery would lead to utilities’ continuing to operate
16 inefficient plants. (This matter has nothing to do with the economic concept of “barriers to
17 exit.”) That is, Dr. Rose seems to believe that a utility would continue to operate a
18 generation plant even if the plant cost more to operate than it was able to earn in the market.
19 This may have been true under traditional regulation, where the “used and useful” standard
20 could have provided an incentive to keep uneconomic plants in operation, but it certainly
21 will not apply in the deregulated generation market of the future.

22 On the other hand, Dr. Rose may assume that Arizona’s stranded cost recovery
23 mechanism will be so poorly designed that it will require specific plants to run, regardless
24 of their relative competitiveness. This is another straw-man. Most parties to this
25 proceeding seem to understand that what matters is making sure that generators compete on
26 a going-forward basis. For example:

1 Stranded cost does not include any operating cost. If a facility's operating costs
2 can not be recovered in a competitive market, economic rationality dictates that
3 the facility be shut down. (Higgins, p. 5.)⁹

4 Q. PLEASE EXPLAIN THE TERM "MORAL HAZARD" IN THE CONTEXT OF
5 STRANDED COST RECOVERY.

6 A. Moral hazard is economic jargon for the phenomenon that people with insurance are more
7 likely to engage in risky behavior. In this case, Dr. Rose asserts that allowing a utility to
8 recover its stranded costs will remove any incentive the utility would otherwise have to
9 mitigate stranded costs.

10 Q. DOES STRANDED COST RECOVERY CREATE A MORAL HAZARD PROBLEM?

11 A. No. A properly designed stranded cost recovery mechanism will not lead to a moral hazard
12 problem. However, a poorly designed mechanism, such as Dr. Rose assumes will be
13 implemented in Arizona, could create a moral hazard problem. For example, if the utility
14 received an iron-clad guarantee of recovering all stranded costs, rather than just an
15 opportunity, it might have less incentive to mitigate stranded costs. Less mitigation effort
16 by the utility would lead to higher costs for customers. Of course, failing to control costs as
17 you are heading into a competitive setting would - or should - be at least as great a concern
18 to shareholders as it is for customers. The potential for moral hazard has been recognized
19 and addressed in those states that have made significant progress toward implementing
20 competition in electricity. Other witnesses in this case seem well aware of this fact. For
21 example,

22 The most efficient approach to mitigation would be one in which the utility was
23 at risk for a portion of its potentially stranded cost, and stood to gain financially
24 when its mitigation actions were successful. (Higgins, p. 31.)

25 Q. PLEASE COMMENT ON DR. ROSE'S CLAIM THAT STRANDED COST RECOVERY
26 WILL CREATE AN ASYMMETRY OF RISK AND REWARD.

⁹ However, as noted in the Direct Testimony of Charles E. Bayless (p. 13, lines 4-5), there may be some generation-related operating costs that should appropriately be included as potentially stranded costs.

1 A. Dr. Rose says:

2 Recovery of uneconomic costs can distort the competitive market because of an
3 asymmetry of risk and reward that is created....[W]ith recovery, an affected
4 utility is compensated for investments that turn out to be uneconomic; but for
5 utilities that have competitive gains, there is no mechanism being proposed to
6 pay the gains back to ratepayers. When calculating uneconomic costs, it is good
7 practice to determine the net amount by offsetting losses with the gains.
8 However, if a utility has a net gain, there is no mechanism to return it back to
9 ratepayers. In effect, only losses are compensated. (page 10.)

10 I have two comments on Dr. Rose's statement. First, he is making another straw-man
11 argument. The use of negative stranded costs to offset positive stranded costs is referred to
12 as "netting." Dr. Rose appears to believe that there will be no netting in Arizona and
13 concludes that because there will be no netting policy, stranded cost recovery should be
14 disallowed. I see no reason to agree with his presumption that there will be no netting
15 policy in Arizona. Consequently, I see no merit in his position that stranded cost recovery
16 should not be allowed because of the absence of netting.

17 Second, although I agree that some sort of netting policy is appropriate, I do not agree
18 with Dr. Rose's assertion that the lack of netting will distort the market. As I have
19 explained above, and as is generally well accepted in electricity restructuring debates in
20 other states, efficiency can only be achieved on a going forward basis. Positive and
21 negative stranded costs are based on sunk costs which are by their nature historical and
22 beyond the power of the utilities and the Commission to make more or less efficient. The
23 treatment of positive and negative stranded costs is crucial for purposes of ensuring fairness
24 and the long-term efficiency of a market economy based in part on government
25 commitments, but it does not impact the ability of the market to clear a forward-looking
26 price for generation.

27 Q. IN YOUR TESTIMONY YOU EXPLAIN THAT THE THREAT OF UNECONOMIC
28 BYPASS MUST BE CONSIDERED IN DESIGN OF A STRANDED COST RECOVERY
29 MECHANISM. DR. ROSE ASSERTS TO THE CONTRARY THAT UNECONOMIC
30 BYPASS "IS LIKELY TO OCCUR ONLY IN A [SIC] VERY LIMITED
31 CIRCUMSTANCES" (ROSE TESTIMONY, P. 11). PLEASE COMMENT.

1 A. I have two responses. First, Dr. Rose's comments are based on a misinterpretation of my
2 testimony. I was discussing the design of stranded cost recovery mechanisms. The point
3 that such mechanisms must be designed to avoid bypass is, I believe, uncontroversial, and,
4 as I have shown above, it is well understood by many of the witnesses in this case.

5 Second, Dr. Rose seems unaware that the potential for uneconomic bypass has been
6 recognized as a potentially significant problem in electricity restructuring for several years.
7 For example, analysts at NRRI had the following to say in their 1994 report on retail
8 wheeling:

9 As correctly maintained by some analysts, retail wheeling in an environment of
10 rigid or embedded-cost retail pricing could lead to uneconomic bypass.
11 Uneconomic bypass implies that the customer switches suppliers because he gets
12 a better deal but economic cost rises....One way to avoid these inefficiencies is
13 to allocate a portion of the stranded-investment costs to wheeling customers. It
14 can be shown that when this occurs a customer would only switch away from the
15 local utility when other suppliers have lower economic costs. (*Overview of the*
16 *Issues Relating to the Retail Wheeling of Electricity*, Kenneth W. Costello,
17 Robert E. Burns, and Youssef Hegazy, NRRI, May 1994, pp. 81-82.)

18 Under TEP's proposal, all customers still have the option of cogeneration and other
19 generation alternatives, but, with a competitively-neutral stranded cost charge reflecting
20 back to the customer the utility's above-market costs, those decisions will be made
21 efficiently based on a comparison of going-forward costs.

22 Q. PLEASE COMMENT ON THE CLAIM OF DR. ROSE (ROSE TESTIMONY, P. 9,
23 LINES 14-25), DR. COOPER (COOPER TESTIMONY, P. 24, LINES 5-11), AND DR.
24 ROSENBERG (ROSENBERG TESTIMONY, P. 7, LINES 14-21) THAT STRANDED
25 COST RECOVERY WILL PROVIDE AN UNFAIR ADVANTAGE TO INCUMBENTS.

26 A. This claim is related to the "barriers to entry" assertion described above. In fact, I find just
27 the opposite more likely to be true. The important matter here is to achieve efficiency on a
28 going-forward basis. To deny a utility a fair chance to recover its stranded costs might
29 seriously hamper the company's financial viability. This would give the company a serious
30 disadvantage in a competitive market where revenues may well be volatile and bankruptcy
31 is a realistic threat for both existing and new market participants. It would be as if the

1 referee were to cut the legs out from under one of the contestants immediately before crying
2 “let the games begin!” Clearly such an act would benefit special interests in the game (such
3 as those of the “competitors”) but it would do nothing to benefit the quality or efficiency of
4 the game itself.

5 Q. TO SUMMARIZE, DO YOU FIND ANY MERIT IN ASSERTIONS THAT STRANDED
6 COST RECOVERY WILL HARM COMPETITION?

7 A. Only if you begin with the assumption that the ACC will handle the issue poorly, which I
8 do not. As I noted, Dr. Rose’s assertions are generally based on a “straw-man” (*i.e.*, the
9 unjustified and unreasonable assumption that Arizona will fail in designing an equitable and
10 competition-neutral stranded cost recovery mechanism where other states have succeeded).

11 Q. ARE YOU THEN SAYING THAT STRANDED COST RECOVERY WOULD HAVE
12 ABSOLUTELY NO EFFECT ON THE DEVELOPMENT AND OPERATION OF THE
13 GENERATION MARKET?

14 A. No. I am merely saying that the kinds of harm which other witnesses have discussed are
15 without any basis in standard economic analysis. There are three types of economic
16 efficiency: technical, allocative, and dynamic. Technical (or first-order) economic
17 efficiency measures the value of resources expended to produce goods and services.
18 Allocative efficiency measures the deviation of prices from incremental costs. Dynamic
19 efficiency measures the incentive to innovate. Stranded cost recovery will undeniably have
20 a negative impact on allocative efficiency, but it will not harm technical or productive
21 efficiency - the benefits of which will still flow to customers.

22 In terms of allocative efficiency, it is true that stranded cost recovery would have the
23 effect of slightly shrinking the market for electricity by maintaining a final product price
24 above marginal cost. If stranded cost recovery is allowed, the final price of electricity to
25 consumers *in the short run* will be higher than otherwise. Since demand is slightly
26 sensitive to price, people would use less electricity than would otherwise be the case. How
27 much less would depend on the sensitivity of demand to price (the technical economic term
28 is “price elasticity of demand”). Economists generally accept that price elasticity of

1 demand for electricity - as for other products regarded as "essential" - is much lower than
2 for many other products regarded as discretionary or nonessential.

3 **V. CONCLUSIONS**

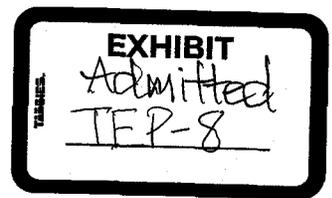
4 Q. DO YOU HAVE ANY CONCLUDING REMARKS?

5 A. Yes. There is one final point that I would like to make about stranded cost recovery in
6 response to the arguments and theories presented by other witnesses. It has to do with the
7 importance of a commitment to an opportunity for full stranded cost recovery in bringing
8 the efficiency benefits of the competitive process to Arizona consumers as quickly as
9 possible. In pointing this out, I do not mean to suggest that stranded cost recovery is not
10 required by an application of proper regulatory principles, but the practical consideration of
11 achieving the ACC's policy goals as soon as possible should not be downplayed.

12 The Massachusetts Commission started the process of investigating the possibility of
13 introducing competition in the generation market in early 1995 while I was Chairman of
14 that Commission. We issued our first order in August of that year, essentially laying out
15 the policy principles that would guide our effort. As I noted in my direct testimony, one of
16 those policy principles was to honor existing commitments and allow an opportunity for full
17 stranded cost recovery. An earlier round of discussion, under the auspices of a
18 gubernatorial task force (of which I was co-chair), failed to reach consensus on how to
19 proceed to open retail electricity markets. Divisions over stranded cost recovery were the
20 main sticking points. It was that failure, in part, which led me to advance the notion of the
21 utility commission enunciating a clear set of principles.

22 I left the Massachusetts Commission soon after the restructuring order was issued, but
23 the effort we had started led to settlement agreements on implementation issues among
24 most of the large investor-owned utilities, the Attorney General (the consumer advocate in
25 Massachusetts), the governor's administration, and some environmental groups. Those
26 settlement agreements, in turn, formed the basis for the legislation that passed late last year,
27 which provided for retail access to begin in Massachusetts on March 1, 1998 - about a
28 month from now. From start to finish, that effort took just about three years.

1 I firmly believe that the Massachusetts Commission's early and unequivocal pledge to
2 honor existing commitments was the primary reason that customer choice will now become
3 a reality in that state. Compare that situation to New Hampshire, which in some ways was
4 moving faster than Massachusetts but is now mired in litigation primarily because there is
5 not a similar commitment to an opportunity for full stranded cost recovery. The benefits of
6 competition to New Hampshire ratepayers are being delayed as a result. The ACC - as I
7 understand it, the only body in Arizona with the jurisdiction to bring about electric
8 restructuring - is at a critical juncture where it can follow the New Hampshire path of
9 litigation and delay, with little prospect of ultimately winning the battle in my opinion, or
10 the Massachusetts path of cooperation and progress toward solving the implementation
11 details of introducing customer choice so that the residents of Arizona can receive the
12 benefits of competition in generation as soon as possible.



REBUTTAL TESTIMONY OF KENNETH GORDON

SUMMARY

My name is Kenneth Gordon. I am Senior Vice President of National Economic Research Associates, Inc. (NERA). My business address is One Main Street, Cambridge, MA 02142. I filed direct testimony in this case before the Arizona Corporation Commission (ACC) on behalf of Tucson Electric Power Company (TEP). The purpose of my rebuttal testimony is to respond to certain arguments and assertions made in testimony that was filed on January 21, 1998 by a number of parties representing a diverse group of interests.

In my rebuttal testimony, I make the following points, among others:

- The term “regulatory compact” is a shorthand way of referring to the understanding between regulators and investors that regulators afford an opportunity to recover all prudently incurred costs, in exchange for the utility assuming an obligation to serve all customers who want service, at rates that cover the cost of capital but do not allow the firm to earn economic profits. My testimony is that utility investors should be given a reasonable opportunity to recover 100 percent of their stranded costs - not that they should be guaranteed recovery of 100 percent of stranded costs.
- Regulators and policymakers are now and always have been free to alter the terms of the regulatory compact on a going-forward basis - and I am a long-time advocate of doing so through the adoption of performance-based regulation, and, even more importantly, through the introduction of competition - but it is inappropriate to ignore the past or apply the substantive standards of the new, competitive model to previous arrangements that were consummated under the soon-to-be discarded standards of rate-base regulation.
- Proposals to share the responsibility for stranded cost recovery 50/50 between ratepayers and shareholders have a certain “split the baby” surface appeal to them, but these proposals are not derived from a reasonable reading of the historic record and the precedent established over many years of traditional ratemaking. Splitting the difference is not justice when anything less than an opportunity to recover 100 percent of stranded costs represents an abrogation of existing commitments.
- Securitization is simply a way to convert a portion of any reasonably estimated stranded costs into a marketable security. Investors are likely to require a smaller risk premium for these securities and thus the capital carrying costs could be lower. Lower capital costs reduce the total stranded costs that customers must pay for.

- Stranded cost recovery can be achieved in ways that have virtually no impact on efficient, going-forward competition in the generation market. Indeed, avoiding deleterious effects on the new generation market is one of the most important goals established by policy-makers in those states that have made significant progress toward the creation of a competitive electricity market. Policy-makers in these states have recognized that, whatever has happened in the past, competition in the generation market should be unimpeded on a going-forward basis. Stranded cost recovery can and has been designed in such a way as to allow the market to clear the price for generation in other markets. There is no reason to believe that the ACC cannot do the same. The “net revenues lost” approach is one such way to accomplish this goal.
- I firmly believe that the Massachusetts Commission’s early and unequivocal pledge to honor existing commitments was the primary reason that customer choice will now become a reality in that state. Compare that situation to New Hampshire, which in some ways was moving faster than Massachusetts but is now mired in litigation primarily because there is not a similar commitment to an opportunity for full stranded cost recovery. The ACC is at a critical juncture where it can follow the New Hampshire path of litigation and delay, with little prospect of ultimately winning the battle in my opinion, or the Massachusetts path of cooperation and progress toward solving the implementation details of introducing customer choice so that the residents of Arizona can receive the benefits of competition in generation as soon as possible.