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BEFORE THE ARIZONA CORPORATION COMMISSION

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

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

DOCKET NO. U-0000-94-165

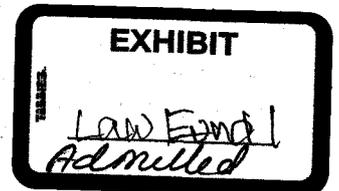
TESTIMONY OF

JAMES F. (RICK) GILLIAM

ON BEHALF OF

THE LAND AND WATER FUND OF THE ROCKIES
AND THE GRAND CANYON TRUST

JANUARY 21, 1998



1 INTRODUCTION & SUMMARY

2 Q. Please state your name, your title, and whom you represent.

3 A. My name is James F. (Rick) Gilliam. I am employed by the Land and Water Fund of the
4 Rockies Energy Project (LAW Fund) as its Senior Technical Advisor. In this proceeding,
5 I am representing the LAW Fund and the Grand Canyon Trust.
6

7 Q. Please describe your responsibilities.

8 A. My responsibilities for the LAW Fund include review and analysis of existing, and the
9 development of new, statutes, regulations, policies, practices, and procedures which may
10 affect the development and promotion of electric resources less harmful to the environment
11 than traditional utility resources. In addition, I also participate in certain forums created to
12 address air quality issues, particularly in Colorado.
13

14 Q. Please summarize your background and experience in electric utility matters.

15 A. Prior to joining the LAW Fund in 1994, I was employed by Public Service Company of
16 Colorado (PSCo), an electric, gas, and thermal energy investor-owned utility, for nearly 12
17 years as its Director of Revenue Requirements. In that position, I was responsible for
18 preparing financial and regulatory studies for PSCo and its Colorado and Wyoming
19 subsidiaries. Among other things, these studies were used in formal rate proceedings, in
20 merger and acquisition decisions, and in determining project impacts. In addition, I was
21 responsible for preparing analyses depicting the separation of the electric utility into its
22 functional components.
23

24 Before joining PSCo I was employed by the Federal Energy Regulatory Commission in
25 Washington DC for six years as an engineer in its Electric Rate Investigations Division. I
26 hold a B.S. in electrical engineering from Rensselaer Polytechnic Institute in New York,
27 and am nearing completion of a Masters Degree in Environmental Policy and Management
28 from the University of Denver.
29

30 Q. Please describe the LAW Fund.

31 A. The LAW Fund is a regional non-profit environmental law center founded in 1990 to
32 provide legal and policy assistance to community groups throughout the Rocky Mountain
33 and Desert Southwest region. The LAW Fund's Energy Project was established in 1991

1 to advocate for sustainable energy policy and practices in a variety of state and national
2 forums.

3
4 Q. Please describe the Grand Canyon Trust.

5 A. The Grand Canyon Trust is a non-profit, regional conservation organization dedicated to
6 the conservation of the natural and cultural resources of the Colorado Plateau. The Trust
7 began its work in 1985, currently has 5,000 members, and is headquartered in Flagstaff,
8 Arizona, with offices in St. George and Moab, Utah. The Trust is committed to the
9 development of clean, renewable energy sources and the efficient use of our current energy
10 resources.

11
12 Q. What is the interest of the environmental groups in this proceeding?

13 A. On December 26, 1996, the Arizona Corporation Commission (ACC or the Commission)
14 issued Decision No. 59943 in this docket adopting proposed competitive electric rules as a
15 framework for the transition to a competitive environment. In that decision, the
16 Commission noted:

17 The parties were generally in agreement that competition will provide the
18 benefit of reduced costs, at least for some consumers. However, there
19 were concerns raised regarding the quality of service, as well as concerns
20 that not all customers, particularly residential customers, will receive the
21 benefits of competition as quickly as some large industrial customers.
22 And of course, the incumbent utilities were greatly concerned regarding
23 the recoverability of stranded costs.
24

25 The impact of accelerated recovery of uneconomic costs related to the production of
26 electricity in Arizona (stranded costs) is potentially so large as to overwhelm utility public
27 interest obligations and the benefits of a competitive energy market itself. We are
28 concerned that unless recovery of legitimate, unmitigated stranded costs is kept within
29 reasonable bounds, that the Commission's Restructuring Rule (the Rule) may result in a
30 rate increase, potentially squeezing out the funding for important public interest benefits.

31
32 Indeed, Tucson Electric Power (TEP) witness Gordon, in providing rationale to support
33 recovery of stranded costs (p. 7), indicates that "Unless special provision is made by
34 legislators and/or regulators, shareholders may not recover fully the funds they provided
35 the company in good faith while the old system was in effect." We respectfully point out

1 that public interest stakeholders accepted utility renewable resource goals in similar good
2 faith under the "old" systems. The utilities have fallen far short of meeting these goals.

3
4 Q. Please summarize your testimony.

5 A. My testimony addresses the calculation and rate recovery methods for stranded costs, and
6 their mitigation. These issues are critically important to public interest considerations and
7 to the success of a competitive electricity market.

8
9 With respect to the method of calculation of stranded costs, we believe full divestiture of
10 assets in the open market would provide the best result. Recognizing that the ACC may
11 not have the necessary authority to order divestiture, and that an administrative estimation
12 approach may be required, we recommend that the Commission take non-price factors into
13 consideration in determining the market value of assets potentially stranded in a
14 competitive market.

15
16 Second, a poorly designed recovery mechanism for stranded costs can have a detrimental
17 effect on the incentives for customers to use energy efficiently and consider on-site
18 distributed renewable generation. The design of the cost recovery mechanism should
19 mirror current cost-recovery practices, i.e. recover stranded costs on a demand or energy
20 basis. In addition, we recommend as the final step in the determination of stranded cost
21 recovery, that the Commission consider the amount of electricity generated by renewable
22 resources owned by the Affected Utility, consistent with R14-2-1607(I). Amounts
23 necessary to remedy any shortfalls in meeting renewable resource goals by the end of the
24 year 2000 should be funded through an increase in the System Benefits Charge and a
25 commensurate reduction in the stranded cost charge. This approach effectively eliminates
26 additional rate impacts for the Affected Utility to achieve its renewable resource targets.

27
28 Finally, several specific stranded cost mitigation methods are described which fall within
29 Rule Section R14-2-1607(A).

30
31 Q. Please describe how your testimony is organized.

32 A. Following a brief discussion of the potential magnitude of stranded costs and
33 corresponding rate impacts in Arizona, my testimony is organized consistent with the

1 issues outlined in the December 1, 1997 Procedural Order of the Chief Hearing Officer in
2 this proceeding. The following issues are addressed in order in this testimony:

- 3 3. What costs should be included as part of "stranded costs" and how should those
4 costs be calculated?
5 6. How and who should pay for "stranded costs" and who, if anyone, should be
6 excluded from paying for stranded costs?
7 9. What factors should be considered for "mitigation" of stranded costs?
8

9
10 STRANDED COSTS IN ARIZONA

11 Q. Are you aware of any estimates of stranded costs for Arizona utilities?

12 A. Yes. In August 1995, Moody's Investor Service issued a report entitled "Stranded Costs
13 Will Threaten Credit Quality of U.S. Electrics." In this report, Moody's estimated
14 stranded costs for Arizona Public Service (APS) and TEP to be about \$1.5 and \$1.2
15 billion, respectively.

16
17 Separately, the Goldwater Institute, in its recent report "The ABC's of Stranded Costs,"
18 noted three independent stranded cost estimates for APS and TEP that average \$1.29
19 billion for the former, and \$943 million for the latter. The exact figure is not critical at this
20 juncture to understand the potential impact of accelerated stranded cost recovery. Suffice
21 to say that the stranded cost estimates for the major Arizona utilities are quite large.

22
23 Q. Can you estimate the impact of stranded cost recovery on the prices charged to Arizona
24 ratepayers?

25 A. Yes. Assuming no change in the magnitude of costs being recovered, the rate impact will
26 amount to the difference in recovery methods between the current regulated system and the
27 future competitive system. The customers of the Affected Utilities are presently paying
28 through existing tariffs the costs which may be stranded in a competitive market. For
29 example, a cost, potentially stranded (i.e. uneconomic) in a competitive environment, may
30 have 30 years remaining in the current regulatory recovery system. If the recovery of this
31 cost is accelerated to a ten year time period as Staff suggests, ^{in the Working Group Report} one would expect the
32 incremental rate effect to be a threefold increase, all else being equal. The following chart
33 lays out a simplified sample calculation of the potential rate impact of accelerated stranded
34 cost recovery over periods of ten and five years.

		Present Rate Recovery	Stranded Cost Charge "A"	Stranded Cost Charge "B"
1	Uneconomic Cost	\$2.4 billion	\$2.4 billion	\$2.4 billion
2	Recovery period	30 Years	10 Years	5 Years
3	Annual Cost Recovery	\$80 million	\$240 million	\$480 million
4	Incremental Cost Recovery	---	\$160 million	\$400 million
5	MWh Sales	25,000,000	25,000,000	25,000,000
6	Cost/kWh	0.32¢	0.96¢	1.92¢
7	Incremental Rate Impact	---	0.64¢	1.60¢
8	Average Rate Impact - %*	---	8.5%	21.3%

* Assuming an average rate of 7.5¢.

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3

4

Q. What is the relevance of these rate impacts to the interests of the environmental community?

5

6

A. The interests of the environmental community are generally addressed in other parts of the Rule. For example, the System Benefits Charge is a wires charge intended to recover the annual cost of demand-side management, renewable, low-income, environmental, and nuclear decommissioning programs. Estimates for the System Benefits Charge are in the range of one to two mills (excluding decommissioning), versus about 10 times that amount for the incremental increase related to the acceleration of recovery of costs potentially stranded in a competitive environment.

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3. What costs should be included as part of "stranded costs" and how should those costs be calculated?

23

Q. What are stranded costs?

24

A. The Rule defines stranded costs as "the verifiable net difference between:

25

- a. The value of all the prudent jurisdictional assets and obligations necessary to furnish electricity (such as generating plants, purchased power contracts, fuel

26

1 contracts, and regulatory assets), acquired or entered into prior to the adoption of
2 this Article, under traditional regulation of the Affected Utilities; and
3 b. The market value of those assets and obligations directly attributable to the
4 introduction of competition under this Article.”
5

6 Q. Do you agree with this definition?

7 A. Conceptually, yes. However, it may not be clear that the “value under traditional
8 regulation” refers to book value, and only to competitive services such as the production of
9 electricity. While necessary to furnish electricity, transmission and distribution facilities
10 will continue to be subject to traditional regulation and are not, in our view, part of the
11 stranded cost calculation. The Stranded Cost Working Group (WG) Report discusses part
12 (a) of this definition at some length, ultimately noting that the working group agreed to
13 leave the definition unchanged.
14

15 The market value (b), is obviously critical to the determination of stranded costs. It
16 received relatively little discussion in the WG Report, which focuses on the price
17 component of market value, possibly leaving the impression that market clearing price is
18 the only relevant factor necessary to determine market value. The pre-filed testimony of
19 the Affected Utilities also fails to address factors affecting market value other than price.
20 This lack of attention to other factors might lead one to believe that any cost of energy
21 supply above the marginal cost of energy (or spot price at Palo Verde) would be stranded
22 in a competitive world. This is simply not the case, as is discussed in more detail below.
23

24 Q. How can stranded costs be determined?

25 A. A subcommittee of the Working Group discussed this issue in detail, describing four
26 potential methods of calculation. Two of these are administrative, and two are market-
27 based. Without question, the best way to determine the market value of any asset is to sell
28 that asset in the marketplace. For example, the market value of a house can be estimated
29 through an appraisal (requiring consideration of many factors), or determined precisely
30 through its sale. In the electric supply industry, non-nuclear electric production assets sold
31 on the open market in New England commanded a 45% premium over book value, while
32 those of Pacific Gas and Electric in California yielded a 32% premium. Other recent
33 purchases of generation assets have generated much larger premiums.
34

1 Selling electric generation assets in the marketplace (the WG Report designates this
2 method as "auction and divestiture") not only provides an accurate measurement of the
3 actual market value, but also mitigates the market power of the incumbent utility. Such a
4 result has the potential to speed effective competition among Electric Service Providers
5 (ESPs) in Arizona.

6
7 Q. What position have the Affected Utilities taken in this proceeding?

8 A. Testimony of the Affected Utilities in this proceeding appear to favor the Net Revenues
9 Lost method of administratively estimating stranded costs, although Tucson Electric Power
10 agrees that divestiture of assets is also a feasible approach.

11
12 Q. What is the relevance of the method of stranded cost determination to the customers of the
13 incumbent utilities?

14 A. The potential impact of stranded cost recovery on Arizona ratepayers is enormous. The
15 choice of calculation method should not penalize customers. Customers should certainly
16 be no worse off, i.e. pay higher stranded cost amounts, than they would have been had a
17 full auction and divestiture taken place. In other words, ratepayers should not be required
18 to pay costs to the incumbent utility that a willing third party would pay in the market.
19 Indeed, the price that would be obtained by selling these assets on the open market should
20 effectively serve as a floor for market value.

21
22 To the extent that the incumbent utility might have sold certain assets to third parties for
23 an amount exceeding an administratively determined market value, customers effectively
24 subsidize those assets for the incumbent. Thus, the method selected for determination of
25 stranded costs must reflect the market value to the owner of those assets.

26
27 Q. This discussion focuses on the market value of generation assets to non-incumbent
28 competitive energy suppliers in the Arizona market. Is the market value the same for an
29 incumbent utility that retains ownership of these generation assets as a competitive energy
30 supplier itself?

31 A. Not necessarily. A non-incumbent competitive energy supplier will base its estimate of the
32 market value it is willing to pay for generation assets on a net present value of future cash
33 flows from the revenue related to sales of the generators output. Components of that

1 calculation include the market share (i.e. quantity or sales volume) it can achieve and the
2 price at which it can sell the output. Because incumbent utilities will likely be the default
3 providers, and can potentially charge higher prices, a similar cash flow calculation for the
4 incumbent will yield a greater value for the assets.

5
6 Q. Please explain.

7 A. A non-incumbent new entrant ESP, in estimating the amount it would be willing to pay for
8 generating assets, would probably use a market clearing price estimate as the minimum
9 rate it could charge for energy produced. It may add a premium if it believes it could
10 charge a slightly higher amount based upon its assumed effectiveness in its marketing
11 efforts, and so forth.

12
13 On the other hand, the value of those assets to an incumbent utility, based on net present
14 value of future cash flows, would also reflect the price it believes it could receive in the
15 competitive market. The incumbents however, have certain advantages that can affect the
16 market price it can command. Use of a market clearing price such as the Palo Verde Index
17 in isolation presumes that every customer would opt for the lowest price offered from any
18 energy supplier, and that in order to be competitive, incumbent utilities must recover
19 through a non-bypassable charge all costs in excess of that amount.

20
21 In all fairness, there may be a few customers, particularly large customers, that may opt
22 for the least expensive energy resource. Such large customers tend to be sophisticated
23 users of energy, having one or more employees responsible for energy management.
24 Conversely, the majority of customers, especially smaller customers, will take other factors
25 into consideration as well.

26
27 Q. What are some of these other factors?

28 A. There is a body of evidence that indicates that non-price characteristics such as reliability,
29 environmental impact, name recognition, customer awareness, degree of effort required,
30 and so forth affect customers' decisions regarding selection of an energy supplier. These
31 considerations may allow an incumbent utility to charge higher prices for the energy it
32 provides in a competitive market, thereby reducing the amount of stranded cost exposure.

33

1 Q. Can you explain how this may reduce stranded cost exposure?

2 A. Yes. Below are some sample assumptions and calculation of stranded cost for a
3 hypothetical utility. Recognize that the value of the sample attributes expected to be
4 considered by customers other than price are estimates for illustrative purposes only.

	(Cost or Rate per kWh)	Price Only	Other Factors
1	Incumbent Cost of Service	7.5¢	7.5¢
2	Transmission/Distribution Cost	2.0¢	2.0¢
3	Net Energy Supply Cost of Service	5.5¢	5.5¢
4	Market clearing price	3.5¢	3.5¢
5	Reliability value	---	0.2¢
6	Name recognition value	---	0.1¢
7	Customer awareness/confusion	---	0.1¢
8	Customer inertia	---	0.1¢
9	Total market value	3.5¢	4.0¢
10	Net stranded costs	2.0¢	1.5¢

5

6 This chart shows that consideration of market clearing price alone may yield a higher
7 stranded cost amount than will comprehensive consideration of other characteristics.

8 Costs are only stranded if they are not recoverable in a competitive market. To the extent
9 that an incumbent utility can command a higher price for energy sold in the competitive
10 market than the market clearing price, the market value of the related assets is also higher
11 and stranded costs are thus reduced.

12

13 Q. TEP witness Bayless proposes a much modified definition of stranded costs in this
14 proceeding. Would you care to comment on his proposal?

15 A. Yes. Mr. Bayless's definition codifies the very problem I address with respect to the
16 distinction between market value and market price. His definition, as I read it, would
17 effectively change market value to "prices based on marginal cost." Later in his testimony
18 however (at page 13), he describes the net revenues lost stranded cost calculation method
19 as using "the [revenue] amounts likely to be realized after the introduction of competition."
20 While this description implicitly recognizes the prices incumbent utilities may charge for
21 electricity in a competitive market, he goes on to equate these prices with the "market's
22 marginal costs." For all the reasons described above, this could overstate stranded costs
23 and lead to a potential windfall for incumbent utilities.

24

1 Q. Are there any other examples that might help to clarify the market value versus market
2 clearing price issue?

3 A. Yes. The telecommunications system was radically changed by the 1982 consent decree
4 requiring AT&T to divest its local operating companies. The seven regional Bell operating
5 companies were barred from providing long-distance service, but rather provided open
6 access to alternative providers of long-distance service. More than 13 years after
7 competition in the long-distance market was introduced, AT&T's share of the long-
8 distance market still exceeded 50% (second quarter of 1997), despite higher prices and
9 lack of stranded cost recovery. Clearly, a large number of customers consider factors
10 other than price in their choice (or non-choice) of an alternative carrier.

11
12 A number of these factors were identified in a 1987 survey of residents of Champaign and
13 Urbana, Illinois. Some of the characteristics relevant to these telecommunications
14 customers' choice of long-distance provider were voice transmission quality, convenience
15 of use, good customer service, low cost, stable company, range of services offered, and
16 past experience with the company. Interestingly, cost ranked fourth as a moderately or
17 very important factor to the respondents.

18
19 Q. What relevance does this have to the restructuring of the electric utility industry?

20 A. The WG Report discusses the risks of estimating market clearing price (p. 31), noting a
21 direct relationship between price and quantification of stranded costs, again implying that
22 market clearing price is equivalent to market value. It goes on to note supply-side factors
23 that can affect market price such as market structure, transmission capacity availability,
24 fuel mix, etc. It did not mention, however, factors affecting the consumer's perception of
25 value. We believe electric customers will consider non-price factors in their choice of
26 electric supplier. One would expect that a rational customer would select the lowest cost
27 provider, but for the values implicitly assigned to non-price factors. If such value exceeds
28 anticipated cost savings related to price, that customer is likely to remain a customer of the
29 incumbent. Put another way, the customer will select the "best-value" provider of energy
30 service.

31
32 Some evidence is provided by the restructuring of the California electric industry. As part
33 of the restructuring, all electric consumers receive a 10% price reduction, regardless of

1 supplier. Non-incumbent service providers may not be able to offer significant discounts
2 beyond the 10%. Thus, non-price factors may easily overwhelm price considerations. An
3 article published in the December 31, 1997 Wall Street Journal noted that only a tiny
4 percentage of California's electric consumers have opted to switch power suppliers.

5 "Barely 20,000 of the 9.9 million customers who buy their electricity from
6 the state's three big investor-owned utilities have decided to dump their
7 hometown supplier in favor of a competing company."
8

9 Q. What is your recommendation to the Commission with respect to consideration of these
10 non-price factors in this proceeding?

11 A. We recommend that the Commission consider non-price factors in its determination of
12 stranded costs for each Affected Utility, to the extent the Affected Utility seeks to use an
13 administrative approach in its stranded cost filing.
14
15

16 **6. How and who should pay for "stranded costs" and who, if anyone, should be**
17 **excluded from paying for stranded costs?**
18

19 Q. Do you have any comments with respect to the method of stranded cost recovery from
20 customers?

21 A. Yes. We believe it's important to apply the stranded cost charge, designed on a volumetric
22 basis (i.e. per kW and/or kWh), to the amount of demand and/or energy delivered by the
23 wires company to the retail energy consumer, net of any reductions related to energy
24 efficiency or on-site renewable energy resources. This encourages the customer to use the
25 energy it purchases wisely, and provides a stronger incentive for the installation of energy
26 efficiency technologies and distributed renewable energy supplies.
27

28 Q. Please explain.

29 A. When a customer is making a decision regarding replacement of existing electric devices
30 (lighting, appliances, heating, pumping, etc.), the higher cost of more efficient devices is
31 offset by the cost savings related to reduced electricity consumption. Similarly, when a
32 customer is making a decision regarding the installation of a rooftop PV panel, the cost
33 savings related to the reduction in electricity consumption offsets the cost of the panel.
34 Thus, the incentives inherent in current rate design should not be compromised.

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Q. Are there other reasons to utilize a volumetric approach?

A. Yes. Section 1607(J) of the Restructuring Rule requires that “any reduction in electricity purchases from an Affected Utility ... shall not be used to calculate or recover any Stranded Cost from a consumer.” The only administratively efficient way to properly capture volumetric changes, i.e. demand and energy reductions, is with a volumetric charge. Moreover, new technologies such as electric vehicles could place large new demands for electricity on the ESPs in Arizona. A usage-based (kW and/or kWh) charge that captures this new growth in use/customer will recover stranded costs at a more rapid rate, potentially reducing the amortization period required, and accelerating effective electricity competition.

Q. Does stranded cost recovery as a volumetric charge alone provide the incentive to encourage the customer to install a solar electric resource, such as rooftop PV?

A. No. The Commission should assure that the energy generated by such systems does indeed reduce the energy required by the customer of its ESP. This not only provides a cost reduction incentive to the customer, but also obviates the need for separate metering of the solar system, thereby reducing the transaction costs of installing the system.

Q. How do you suggest that the Commission assure that existing incentives are not compromised?

A. We urge the Commission to maintain the current volumetric charge for potentially stranded costs. Further, we recommend that the Commission establish a policy that solar electricity generation on a customer’s site be netted against that customer’s energy usage, and not be separately metered.

Q. Did you see anything in the testimony of the Affected Utilities that might lead you to believe that anything other than a volumetric charge was contemplated?

A. No, I did not.

RENEWABLE GENERATING RESOURCES

Q. What is the relationship between stranded costs and renewable resources?

1 A. Section 1607(I) of the Restructuring Rule indicates that after hearing, the Commission, in
2 making its determination of mechanisms and charges shall consider:

3 "The amount of electricity generated by renewable generating resources
4 owned by the Affected Utility."
5

6 Thus, to the extent that an Affected Utility is progressive in its development of renewable
7 generating resources, the Commission should provide more assurance of stranded cost
8 recovery. Indeed, Affected Utilities that are perceived as "green" by electric consumers
9 are likely to have an advantage in their marketing and customer retention efforts.
10

11 Q. Is there a historical context for renewable resource development in Arizona?

12 A. Yes. In the 1993 Integrated Resource Planning Docket (No. 93-052), APS indicated that it
13 is willing to strive toward a "goal" of 12 MW for renewables by 2000 and TEP indicated
14 that it is willing to strive toward a goal of 5 MW for renewables by 2000. The
15 Commission responded in its opinion and order:

16 "We [the Commission] regard these statements as serious commitments
17 and will accept them as planning goals. However, if APS and TEP
18 appear to fall significantly short of meeting these goals, we shall
19 reconsider short-term set asides."
20

21 Q. Have the utilities fallen short of meeting these commitments?

22 A. In my opinion, they have. Moreover, TEP witness Fessler, in his testimony summary,
23 admonishes the Commission that "it is obligated to keep faith with past commitments."
24 We urge the Commission to hold utilities to the same standard.
25

26 Q. What do you recommend the Commission do in this proceeding?

27 A. We recommend that as the final step in the determination of stranded costs for these
28 utilities, the Commission project the portion of the renewable resource goals achievable by
29 the year 2000 for the Affected Utilities. To the extent that potential shortfalls of their
30 renewable resource goals are projected, the Commission can then increase the System
31 Benefits Charge to recover the amounts necessary for the Affected Utilities to achieve their
32 renewable resource goals, and reduce stranded cost recovery by an equal amount. In this
33 way, renewable resource goals can be attained without additional price burdens on
34 customers.
35

1
2 **9. What factors should be considered for “mitigation” of stranded costs?**
3

4 Q. What does the Restructuring Rule indicate with respect to mitigation strategies which may
5 reduce the rate impact?

6 A. The Restructuring Rule, in Section R14-2-1607 (A) requires the following:

7 The Affected Utilities shall take every feasible, cost-effective measure to
8 mitigate or offset Stranded Cost by means such as expanding wholesale or
9 retail markets, or offering a wider scope of services for profit, among
10 others.
11

12 The WG Report categorizes mitigation strategies into two groups: cost reduction and
13 containment, and revenue enhancement. It identifies a number of strategies noting the lack
14 of consensus on these issues. Staff goes on to suggest that the Rules be modified to
15 “permit each Affected Utility to independently demonstrate that their mitigation efforts
16 were reasonable and cost-beneficial, based on all relevant facts and circumstances.”
17

18 Q. Mr. Hieronymus, witness for APS, indicated that making power markets competitive does
19 not give utilities any material new means of mitigating or reducing costs that they didn’t
20 have previously. Would you agree with his assessment?

21 A. No. Opening competitive markets, particularly at the retail level, provides huge new
22 markets to which utilities may sell energy, thereby generating additional revenue to offset
23 stranded costs. In addition, the potential impact of accelerated stranded cost recovery on
24 customers demands a high level of utility diligence in seeking all means of reducing this
25 impact.
26

27 The Rule goes beyond direct mitigation of stranded costs and suggests offsetting cost
28 reductions as a possible mitigation strategy. Indeed, the Commission may want to
29 investigate incentive mechanisms to promote such cost reductions, as suggested by TEP
30 witnesses Fessler (p. 40) and Gordon (in his summary). I also reiterate that making power
31 markets competitive provides certain advantages for the incumbent utilities as discussed
32 above.
33

34 Q. Do you have any comments with respect to mitigation strategies?

1 A. Yes. In general I agree with Staff's recommendation, however I would like to suggest two
2 relatively painless cost reduction strategies: (1) Capturing growth benefits (a revenue
3 enhancing strategy), and (2) Extending amortization periods (a cost reduction strategy).
4 The former concept relates to the high growth in the Arizona electricity market, growth
5 that has exceeded cost growth for a number of years. Such growth provides an expanding
6 source of revenue which can help offset stranded costs.

7
8 The second method may seem counter-intuitive in some respects, but takes advantage of
9 extending amortization periods for costs already being recovered through rates. The WG
10 Report discusses a mitigation strategy of accelerated depreciation of generation assets or
11 accelerated amortization of regulatory assets. It goes on to acknowledge that cost recovery
12 must accompany the accounting change to keep investors whole. Our suggestion involves
13 a recognition of useful lives and recovery periods, and a commensurate deceleration of
14 costs.

15
16 Q. Please explain.

17 A. The useful lives of many power plants, particularly coal plants, in the West have been
18 extended with commensurate adjustment of depreciable lives. Coal-fired power plants
19 originally designed and built to last thirty years, are now continuing to operate for up to 50
20 years, and perhaps longer. Such changes in lives, when recognized in updated depreciation
21 studies, will result in substantially lower production depreciation expense, and consequent
22 reductions in stranded costs.

23
24 The suggestion for regulatory assets is conceptually similar, but easier to achieve. They
25 represent another balance sheet item with a specified amortization period. To the extent
26 that the Commission approves a longer amortization period, costs and required customer
27 revenue can be reduced. This strategy doesn't actually reduce stranded costs, but rather
28 offsets them with a separate cost reduction.

29
30 Q. Can you provide an example?

31 A. Yes. Mr. Davis indicated in his testimony that, for APS, all regulatory assets are being
32 amortized and collected through rates by 2004. He suggests that there is no need to
33 address them as stranded costs. I agree. However, with the start of competition there will

1 be five years of regulatory asset amortization remaining to be collected through tariffed
2 rates. By stretching this amortization period out to the period chosen for stranded cost
3 recovery (anything longer than five years), an annual cost reduction will occur. This
4 reduction can help offset the increase related to the acceleration of stranded cost recovery.
5 Adjustment of the amortization periods for other balance sheet items should be examined
6 as well.

7
8 Q. Do you have a recommendation?

9 A. Yes. I recommend that as an integral part of their stranded cost filings, Affected Utilities
10 be required to:

- 11 (1) estimate the potential mitigation benefits of customer and revenue growth, and
12 (2) provide an assessment of changes to amortization periods of balance sheet items
13 that may offset cost and price increases related to stranded cost recovery.

14
15 CONCLUSION/RECOMMENDATION

16 Q. Would you summarize your recommendations for language changes in the Rule?

17 A. Yes. We recommend that a new subsection (12) be added to R14-2-1607(I) which reads
18 as follows:

- 19 12. The value and effect of non-price factors on calculation of the market value
20 element of the stranded cost definition.

21
22 Q. Would you summarize your recommendations for clarifications in the Rule?

23 A. We recommend that the Commission clarify the definition of stranded cost as follows:

- 24 • the "value under traditional regulation" refers to book value, and
25 • stranded costs are derived only from costs related to the production of electricity.

26
27 We further recommend that as an integral part of their stranded cost filings, Affected
28 Utilities be required to

- 29 • include attributes other than price in any determination of market value,
30 • identify the amount of electricity (demand and energy) generated from company-
31 owned renewable resources,
32 • estimate the potential mitigation benefits of customer and revenue growth, and
33 • provide an assessment of changes to amortization periods of balance sheet items.

1

2

We also recommend that the stranded cost charge be based on demand or energy consumption, i.e. volumetric.

3

4

5

Finally, we recommend that stranded cost amounts be reduced by the dollar amounts necessary for Affected Utilities to achieve their renewable resource goals. These amounts can then be collected through the System Benefits Charge and the renewable resource goals achieved, with no incremental rate impact on customers.

6

7

8

9

10 Q. Does that conclude your testimony?

11 A. Yes, it does.

12

BEFORE THE ARIZONA CORPORATION COMMISSION

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

IN THE MATTER OF COMPETITION IN)
THE PROVISION OF ELECTRIC SERVICES) DOCKET NO. U-0000-94-165
THROUGHOUT THE STATE OF ARIZONA.)
_____)

SUMMARY OF TESTIMONY OF JAMES F. (RICK) GILLIAM
ON BEHALF OF
THE LAND AND WATER FUND OF THE ROCKIES
AND THE GRAND CANYON TRUST

On December 26, 1996, the Arizona Corporation Commission (ACC or the Commission) issued Decision No. 59943 in this docket adopting proposed competitive electric rules as a framework for the transition to a competitive environment. In that decision, the Commission noted:

The parties were generally in agreement that competition will provide the benefit of reduced costs, at least for some consumers. However, there were concerns raised regarding the quality of service, as well as concerns that not all customers, particularly residential customers, will receive the benefits of competition as quickly as some large industrial customers. And of course, the incumbent utilities were greatly concerned regarding the recoverability of stranded costs.

The impact of the accelerated recovery of uneconomic costs related to the production of electricity in Arizona (stranded costs) is potentially so large as to overwhelm other utility obligations and the benefits of a competitive energy market itself. We are concerned that unless recovery of legitimate, unmitigated stranded costs is kept within reasonable bounds, that the Commission's Restructuring Rule may result in price increases, effectively squeezing out funding for important public interest benefits. Thus, stranded cost calculations and recovery methods are critically important to public interest considerations and to the success of a competitive market.

EXHIBIT
Law Fund 2
Admitted

As a preliminary matter, with respect to the definition of stranded costs, we recommend that the Commission clarify that the “value ... under traditional regulation” in Section R14-2-1601(8)a refers to book value, and that stranded costs are derived only from costs related to the production of electricity.

We believe that divestiture of assets in the open market would likely provide the most accurate market value and best market power result. However, we recognize the ACC may not have the necessary authority to require Affected Utilities to divest all or a portion of their production assets. Thus, we recommend that if stranded costs are to be determined utilizing an administrative method, the Commission clarify that market *value* consider factors other than price. For example, the net revenues lost method determines strandable costs as the difference between revenues received by a utility in a continued regulated regime and revenues received by the utility in a competitive energy supply market. In the competitive marketplace, to the extent that customers perceive certain characteristics of the incumbent utility to have value (e.g. reliability, customer service, etc.), then that utility can charge prices for electricity supply, and thus generate revenues, greater than the market clearing price. The greater the competitive revenue generated, the smaller the actual stranded cost.

Second, the recovery method for stranded costs, if improperly designed, could have a detrimental effect on the incentives for customers to use energy efficiently and consider on-site distributed renewable generation. For example, customer payments of stranded costs collected through a flat fee mechanism are unaffected by reductions in energy use related to increased customer efficiency or installation of distributed renewable resources (such as rooftop PV). This method reduces cost recovery risk for utilities below present practices, and reduces the incentive for customers to invest in clean and efficient energy technologies. Further, a flat fee would be at odds with Section R14-2-1607(J) of the Commission’s Restructuring Rule. The design of the cost recovery mechanism should mirror current cost-recovery practices. In other words, any stranded costs deemed recoverable from customers in a competitive market should be allocated consistent with current practices, and the recovery mechanism designed on a volumetric basis (i.e. per kW and/or per kWh).

We also recommend that, as the final step in the determination of stranded cost recovery, the Commission consider the amount of electricity generated by renewable resources owned by the Affected Utility, consistent with R14-2-1607(I). An incentive should be provided through the Commission's stranded cost recovery policy for the Affected Utilities to achieve their renewable resource goals. Amounts necessary to remedy shortfalls in meeting renewable resource goals by the end of the year 2000 should be funded through an increase in the System Benefits Charge and a commensurate reduction in the stranded cost charge. The effect is to make full stranded cost recovery contingent upon the utility achieving its established renewable resource goals. This approach effectively eliminates additional rate impacts for the Affected Utility to achieve its renewable resource targets, while providing a strong incentive for the utility to meet its goals.

Finally, several specific stranded cost mitigation methods are described which fall within Rule Section R14-2-1607(A). First, the revenue enhancement benefits related to Arizona's rapid demand and energy growth should be captured. Second, we recommend that the useful lives of assets potentially strandable in a competitive market be reviewed for possible extension, and commensurate adjustments be made to depreciation and amortization expenses. This *deceleration* of strandable asset recovery can result in a cost reduction for these assets.

BEFORE THE ARIZONA CORPORATION COMMISSION

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

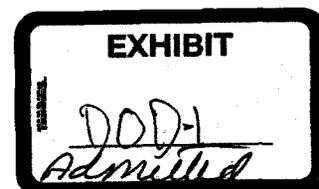
In the Matter of the Competition in the Provision
of Electric Services Throughout the State
of Arizona

Docket No. U-0000-94-165

TESTIMONY OF DAN L. NEIDLINGER

**On behalf of
The Department of Defense and All Other Federal Executive Agencies**

January 21, 1998



ARIZONA CORPORATION COMMISSION

In the Matter of the Competition in the Provision of Electric Services Throughout Arizona
Docket No. U-0000-94-165

Summary of the Testimony of Dan L. Neidlinger on Behalf of the Department of Defense
and all Other
Federal Executive Agencies

Mr. Neidlinger's testimony is limited to Issue 6: "How and who should pay for "stranded costs" and who, if anyone, should be excluded from paying stranded costs?". His recommendations on this issue are as follows:

- 1.) Stranded costs should be categorized as demand-related or energy-related and recovered through a combination of demand and energy charges to customers.
- 2.) Stranded costs should be allocated to customer classes based on sound cost of service principles.
- 3.) Except for self-generators, stranded costs should be recovered from all customers. The charges to standard offer customers should account for the contribution to stranded costs already embedded in standard offer rates.
- 4.) Customers with loads greater than one megawatt should be provided with an option to pay for their stranded costs through a one-time exit fee.
- 5.) All energy-related and a portion of demand-related stranded costs should be recovered from interruptible customers.
- 6.) Stranded costs should be allocated to special contract customers. Recovery of these costs would be a matter for negotiation between the customer and the utility.

ARIZONA CORPORATION COMMISSION

In the Matter of the Competition in the Provision of Electric Services Throughout Arizona
Docket No. U-0000-94-165

Direct Testimony of Dan L. Neidlinger

Q. PLEASE STATE YOUR NAME, ADDRESS AND OCCUPATION.

A. My name is Dan L. Neidlinger. My business address is 3020 North 17th Drive, Phoenix, Arizona. I am President of Neidlinger & Associates, Ltd., a consulting firm specializing in utility rate economics.

Q. PLEASE DESCRIBE YOUR PROFESSIONAL QUALIFICATIONS AND EXPERIENCE.

A. A summary of my professional qualifications and experience is included in the attached Statement of Qualifications. In addition to the Arizona Corporation Commission ("ACC" or the "Commission"), I have presented expert testimony before regulatory commissions and agencies in Alaska, Colorado, Guam, Idaho, New Mexico, Nevada, Texas, Utah, Wyoming and the Province of Alberta, Canada.

Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?

A. I am appearing on behalf of the Department of Defense and all other Federal Executive Agencies. Installations that will be substantially affected by the Commission's decision in this proceeding include Davis-Monthan Air Force Base, Fort Huachuca, Luke Air Force Base and the Yuma Marine Air Station.

Q. DID YOU PARTICIPATE IN THE COMMISSION'S WORKSHOPS HELD IN 1997 ON STRANDED COST ISSUES?

A. Yes. I was a member of both the Calculation Methodologies Subcommittee and the Recovery Mechanisms Subcommittee on stranded costs. My participation in these committees was on behalf of Fort Huachuca.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. My testimony addresses Issue 6 of the Chief Hearing Officer's Original Procedural Order: "How and who should pay for "stranded costs" and who, if anyone, should be excluded from paying for stranded costs?".

Q. ONCE STRANDED COSTS HAVE BEEN QUANTIFIED, HOW SHOULD THE RESPONSIBILITY FOR THESE COSTS BE ASSIGNED?

A. First, all stranded costs should be categorized as demand-related or energy-related to enable recovery of these costs in the same manner as they were originally incurred. Second, a jurisdictional allocation of these costs is required to identify retail and wholesale responsibility. Finally, a retail allocation of stranded costs among all classes of customers should be made using sound cost of service principles.

Q. WHAT ARE "SOUND COST OF SERVICE PRINCIPLES"?

A. Sound cost of service principles require that energy-related costs be allocated on loss-adjusted energy factors and that demand-related costs be allocated on valid demand allocation methods. If any portion of demand-related stranded costs are allocated on energy, customers with higher-than-average load factors will be assigned a disproportionate share of these costs.

Q. ARE THE RATES CURRENTLY CHARGED THE CUSTOMERS OF ARIZONA PUBLIC SERVICE ("APS") AND TUCSON ELECTRIC POWER COMPANY ("TEP") BASED ON EXPLICIT FINDINGS BY THE COMMISSION CONCERNING COST OF SERVICE?

A. No. The rates currently in effect for both APS and TEP are not based on specific customer class cost allocation methods explicitly approved in rate orders of the Commission. Recent rate adjustments for both companies have generally been "across-the-board" in nature due to rate settlements agreed to by the various parties and the Commission. Accordingly, little weight has been given to cost of service in the recent past in the setting of rates for the major classes of customers for APS and TEP.

Q. ARE THE COST OF SERVICE DEMAND ALLOCATION METHODS RECOMMENDED BY APS AND TEP IN RECENT RATE CASES SIMILAR IN NATURE?

A. No. The cost of service demand allocation methods recommended by APS and TEP in recent cases are radically different and, as shown on Exhibit DLN-1, if used to allocate demand-related stranded costs, would produce significant variances in allocations to customers with similar load characteristics. Accordingly, application of disparate demand allocation method among like utilities could result in discriminatory stranded cost recovery practices.

Q. HOW SHOULD DEMAND-RELATED STRANDED COSTS BE ALLOCATED?

A. The same demand allocation method should be used for utilities with similar load profiles. For APS and TEP, both with predominate summer peaks, a 4 month coincident peak ("4CP") method using the months of June through September would be appropriate. A 12CP method would be proper for those electric distribution utilities whose wholesale demand charges remain the same throughout the year.

Q. HOW SHOULD STRANDED COSTS BE RECOVERED?

A. Stranded cost charges should be recovered in the same manner in which they are calculated -- energy-related costs on a KWH basis and demand-related costs on a KW basis. Certain classes of customers, such as residential and small commercial, would pay stranded costs through a KWH charge.

Q. SHOULD EXIT FEES BE PERMITTED?

A. Yes. Exit fees should be an option for larger customers, those with loads exceeding one megawatt, that desire to extinguish their estimated total stranded cost obligation with one check. Exit fees should not be charged to customers that move out of the host utility's service area.

Q. WOULD THESE EXIT FEES BE SUBJECT TO ADJUSTMENT IF "TRUE-UP" PROCEEDINGS ARE ALLOWED?

A. No. Exit fees would not be subject to any adjustment, either up or down, due to true-up proceedings or changes in the customer's load.

Q. WHO SHOULD PAY FOR STRANDED COSTS?

A. With one exception, all customers should pay their fair share of stranded costs including those customers that elect to stay on standard offer rates. The charge to **standard offer** customers, however, should account for the contribution to stranded costs **already embedded in standard offer rates**.

Q. SHOULD THE STRANDED COST CHARGE TO CUSTOMERS WITHIN THE SAME CLASS BE THE SAME FOR CUSTOMERS ELECTING COMPETITION AS THAT CHARGED TO CUSTOMERS UNDER STANDARD OFFER RATES?

A. Yes. Charging different stranded cost amounts would not only be **discriminatory** but would impede the transition to a fully competitive market. Cross-subsidies, among classes of customers and within classes, exist to varying degrees in the present retail rate structures of all Arizona electric utilities. Assigning a different stranded cost charge to the customers electing competition than the charge assigned standard offer customers would merely perpetuate and exacerbate the cross-subsidy problem.

Q. WHAT IS THE EXCEPTION?

A. As a matter of policy, self-generators, both present and future, should not be assigned stranded costs. This is consistent with Section R 14-2-1607(J) of the currently adopted Rule. It would not be unreasonable, however, for utilities to recover a portion of their stranded costs from standby and supplementary power rates and charges to self-generators.

Q. SHOULDN'T INTERRUPTIBLE CUSTOMERS ALSO BE EXEMPT FROM DEMAND-RELATED STRANDED COSTS?

A. Interruptible customers should be exempt from any stranded costs associated with generating facilities or purchased power contracts designed to meet **peak demands**. In general, however, these customers should not be exempt from all other demand-related stranded costs or energy-related stranded costs.

Q. WHAT ABOUT SPECIAL CONTRACT CUSTOMERS?

A. Customers with special contracts subject to the jurisdiction of the **Commission should** receive the same allocation of stranded costs as all other, non-special **contract customers**. This is consistent with the cost of service treatment of these customers in **recent rate proceedings**. The amount of stranded costs collected from these customers would be a **matter for negotiation** between the customer and the utility.

Q. DOES THAT CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes, it does.

**IN THE MATTER OF THE COMPETITION IN
THE PROVISION OF ELECTRIC SERVICES
THROUGHOUT THE STATE OF ARIZONA
Docket No. U-0000-94-165**

**Standed Cost Allocation Comparison
APS vs TEP Demand Allocation Methods**

Customer Class Demands			Allocation of \$1 of Demand-Related Stranded Cost			
Customer Class	Average Demand	Coincident Demand - 4CP	APS Method (1)	Percent	TEP Method (2)	Percent
A	25	50	\$0.50	50.00%	\$0.45	45.00%
B	35	50	0.50	50.00%	0.55	55.00%
Total	60	100	\$1.00	100.00%	\$1.00	100.00%

NOTES:

- (1) APS Demand Allocation Method - 4 Coincident Peak Method
(2) TEP Demand Allocation Method - Average & Peak Method

DAN L. NEIDLINGER

SUMMARY STATEMENT OF QUALIFICATIONS

I. General:

Mr. Neidlinger is President of Neidlinger & Associates, Ltd., a Phoenix consulting firm specializing in utility rate economics and financial management. During his consulting career, he has managed and performed numerous assignments related to utility ratemaking and energy management.

II. Education:

Mr. Neidlinger was graduated from Purdue University with a Bachelor of Science degree in Electrical Engineering. He also holds a Master of Science degree in Industrial Management from Purdue's Krannert Graduate School of Management. He is a licensed Certified Public Accountant in Arizona and Ohio.

III. Consulting Experience:

Mr. Neidlinger has presented expert testimony on financial, accounting, cost of service and rate design issues in regulatory proceedings throughout the western United States involving companies from every segment of the utility industry. Testimony presented to these regulatory agencies has been on behalf of commission staffs, applicant utilities, industrial intervenors and consumer agencies. He has also testified in a number of civil litigation matters involving utility ratemaking and once served as a Special Master to a Nevada court in a law suit involving a Nevada public utility.

Mr. Neidlinger has performed numerous feasibility studies related to energy management including cogeneration, self-generation, peak shaving and load-shifting analyses for clients with large electric loads. In addition, he has conducted electric and gas privatization studies for U. S. Army installations and assisted these and other consumer clients in contract negotiations with utility providers of electric, gas and wastewater service.

Mr. Neidlinger has extensive experience in the costing and pricing of utility services. During his consulting career, he has been responsible for the design and implementation of utility rates for over 30 electric, gas, water and wastewater utility clients ranging in size from 50 to 25,000 customers.

IV. Professional Affiliations:

Professional affiliations include the American Institute of Certified Public Accountants and the Association of Energy Engineers.

BEFORE THE ARIZONA CORPORATION COMMISSION

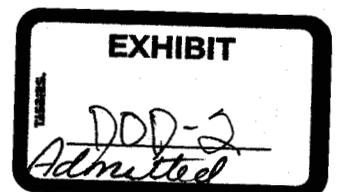
JIM IRVIN
COMMISSIONER-CHAIRMAN
RENZ D. JENNINGS
COMMISSIONER
CARL J. KUNASEK
COMMISSIONER

In the Matter of the Competition
in the Provision of Electric
Services Throughout the State
of Arizona

Docket No. U-0000-94-165
Summary of Rebuttal Testimony
Of Dan L. Neidlinger

Mr. Neidlinger's rebuttal testimony addresses certain portions of the testimonies of Tom Broderick, witness for the Arizona School Boards Association, Inc., Michael K. Block, witness for the Goldwater Institute, Sean R. Breen, witness for Citizens Utilities Company, Enrique A. Lopezlira, witness for the Arizona Attorney General's Office, and the testimonies of Dr. Mark N. Cooper and Albert Sterman, both on behalf of the Arizona Consumers Council. His rebuttal is summarized as follows:

- 1) Mr. Broderick's request that Arizona public schools be exempted from recovery of stranded costs should be denied.
- 2) Stranded costs should not be recovered on a "meters" charge as advocated by Messrs. Block, Breen and Lopezlira but on a combination of KW and KWH charges applied to actual demands and energy usage.
- 3) Dr. Cooper's recommended cost allocation procedure for stranded costs associated with baseload generating plants should not be adopted since it is contrary to sound cost of service principles.
- 4) Except for residential and small commercial customers, stranded costs should not be recovered entirely on a KWH basis as advocated by Mr. Sterman.



ARIZONA CORPORATION COMMISSION

In the Matter of the Competition in the Provision of Electric Services Throughout Arizona
Docket No. U-0000-94-165

Rebuttal Testimony of Dan L. Neidlinger

Q. PLEASE STATE YOUR NAME, ADDRESS AND OCCUPATION.

A. My name is Dan L. Neidlinger. My business address is 3020 North 17th Drive, Phoenix, Arizona. I am President of Neidlinger & Associates, Ltd., a consulting firm specializing in utility rate economics.

Q. DID YOU PREVIOUSLY FILE DIRECT TESTIMONY IN THIS PROCEEDING ON BEHALF OF THE DEPARTMENT OF DEFENSE AND ALL OTHER FEDERAL EXECUTIVE AGENCIES?

A. Yes, I did.

Q. WHAT IS THE PURPOSE OF THIS ADDITIONAL TESTIMONY?

A. The purpose of this additional testimony is to rebut certain portions of the direct testimonies of Tom Broderick, witness for the Arizona School Boards Association, Inc., Michael K. Block, witness for the Goldwater Institute, Sean R. Breen, witness for Citizens Utilities Company, Enrique A. Lopezlira, witness for the Arizona Attorney General's Office, and the testimonies of Dr. Mark N Cooper and Albert Sterman, both on behalf of the Arizona Consumers Council. My rebuttal testimony is limited to Issue 6: "How and who should pay for "stranded costs" and who, if anyone, should be excluded from paying stranded costs?".

Q. DOES THE FAILURE OF YOUR TESTIMONY TO ADDRESS POSITIONS OF OTHER WITNESSES ON ISSUE 6 MEAN THAT YOU AGREE WITH THESE POSITIONS?

A. No, it does not.

Q. DO YOU AGREE WITH MR. BRODERICK'S REQUEST TO EXEMPT ARIZONA PUBLIC SCHOOLS FROM PAYING STRANDED COSTS?

A. No. Mr. Broderick states that Arizona's public schools are currently under-funded and argues that requiring public schools to pay for stranded costs would represent an additional financial hardship that is not in the "public interest". This argument, carried to its extreme, would provide a basis for exempting hundreds of other groups of customers with similar public interest positions and thousands of individual customers that could demonstrate financial hardship. As of now, the Commission has not articulated any detailed policies or guidelines for exempting any customer or groups of customers from stranded costs based on "public interest" considerations or for the treatment of the unrecovered costs from customers exempted. Absent a definitive policy on this issue, the exemption request of the Arizona public schools should be denied.

Q. MESSRS. BLOCK, BREEN AND LOPEZLIRA ADVOCATE RECOVERY OF STRANDED COSTS BASED ON A "METERS" CHARGE RATHER THAN A DEMAND/ENERGY USAGE CHARGE. DO YOU HAVE ANY CONCERNS WITH REGARD TO THESE RECOMMENDATIONS?

A. Yes. As discussed in my direct testimony, stranded costs should be calculated and recovered in the same manner -- demand-related costs on a KW basis and energy-related costs on a KWH basis. Recovery in this fashion gives customers the opportunity to mitigate these charges by altering their energy consumption patterns. A flat meter charge would not provide customers with this opportunity.

Q. DO YOU AGREE WITH DR. COOPER'S RECOMMENDED STRANDED COST ALLOCATION METHODOLOGY?

A. No. Dr. Cooper's recommended stranded cost allocation methodology would improperly assign all of the stranded costs associated with baseload generating facilities to non-residential customers. This allocation method is not a generally accepted method for allocating demand-related costs and should be rejected since it would result in extremely large cross-subsidies among classes of customers. Further, his recommendation that stranded costs be

recovered entirely on a KWH basis would create cross-subsidies among customers within the large commercial or industrial classes due to variances in load factor.

Q. MR. STERMAN ALSO RECOMMENDS THAT STRANDED COSTS BE RECOVERED ENTIRELY ON A KWH BASIS. DO YOU DISAGREE WITH THIS RECOMMENDATION FOR THE SAME REASONS PREVIOUSLY DISCUSSED?

A. Yes. Except for residential and certain small commercial customers who are currently billed on a KWH basis, stranded costs should be recovered through a combination of demand and energy charges.

Q. DOES THAT CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.

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

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing rebuttal testimony of Dan L. Neidlinger on all parties of record in this proceeding by mailing a copy thereof, properly addressed with first class postage prepaid to:

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Dated at San Bruno, California, this 3rd day of February
1998.


Leticia G. Byrd, Secretary

DOUGLAS A. OGLESBY
SUMMARY LIST OF TESTIMONY SUBJECT AREAS

RECEIVED

1. Proposed transfer of competitive assets, bases for valuation, and timing;
2. Definition of "competitive services assets," identification of such assets, and manner of financing acquisition;
3. Calculation and recovery of stranded costs, including use of tracking account;
4. Effect of proposed rate reductions on competition;
5. Advance one-year notification requirement for customer switch-back;
6. APS electricity purchases from a generation affiliate;
7. Methodology for design and development of APS's distribution rate.

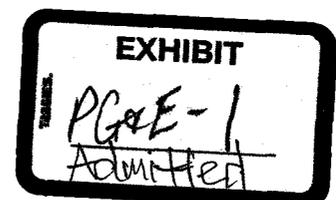
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**BEFORE THE
ARIZONA CORPORATION COMMISSION**

DOCKET NOS. E-01345A-98-0473

E-01345A-97-0773

RE-00000C-94-0165

**TESTIMONY OF DOUGLAS A. OGLESBY
Vice President and General Counsel**

On Behalf of

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PREPARED TESTIMONY
OF DOUGLAS A. OGLESBY

Q. 1. Please state your name, address, professional background and experience, and whom you are representing?

A. 1. My name is Douglas A. Oglesby, 345 California Street, Suite 3200, San Francisco, California. I am Vice President and General Counsel for PG&E Energy Services Corporation ("Energy Services") and am representing it in these proceedings. My background and experience are set forth in Attachment DAO-1. Energy Services affiliate, PG&E Generating Company, also supports the positions set forth in this testimony.

Q. 2. Please summarize your testimony.

A. 2. First, any transfer of competitive service assets (including non-nuclear generation) to one or more of APS's affiliates should be based upon the market value of such assets, not depreciated book value. In that regard, we also believe fair market value should be determined through an auction or an independent, Commission-approved appraisal. Second, we believe the Commission should require APS to provide more detailed information as to (i) what constitutes "competitive service assets" for purposes of Article III and the Settlement Agreement as a whole, (ii) what specific "competitive services assets" are subject to the prospect of transfer to an affiliate, and (iii) how such affiliate(s) would pay for such assets.

Third, we believe a tracking account should be established in connection with APS's

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Recovery of Stranded Costs, rather than a CTC which remains in effect until December 31, 2004.

Fourth, for the reasons indicated, we believe that the proposed rate reductions may have the effect of deterring competition, thereby ironically depriving customers of that option of meaningful choice that both the Commission and the Arizona Legislature have intended.

Fifth, we believe that the proposed one-year advance notification requirement for customers with a load of 3MW or greater is unwarranted in fact, and anti-competitive in its effect - which we suspect is precisely what APS intends.

Sixth, we believe the framework for sales of electricity to APS from a generating affiliate is too vague for purposes of determining what constitutes a "market price." In addition, as long as APS continues to perform a regulated procurement function, its power procurement must be subject to prudence review by the Commission.

Seventh, we believe the Commission should require APS to use a cost-causation approach in developing its distribution rate, thereby specifically identifying and recovering as a "wires only" rate only those costs relevant to distribution service. The credit approach under the Settlement Agreement will permit APS to recover from direct access customers certain non-commodity costs of retail electric service it is no longer incurring, effectively requiring direct access customers to subsidize APS and to pay twice for these costs.

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Q. 3. Who is Energy Services and what is the nature of its business activities?

A. 3. Energy Services is a competitive business unit of PG&E Corporation, a large diversified energy holding company headquartered in San Francisco. Energy Services sells gas and electric commodities and a wide range of other energy-related products and services nationwide, including in Arizona, where it has had an active sales office for about four years. Energy Services's activities are not regulated by the California Public Utilities Commission ("CPUC") or any other state commission, and it is structurally, organizationally, functionally, operationally, and financially fully separate from its utility affiliate Pacific Gas and Electric Company.

Q. 4. Has Energy Services previously participated in proceedings before the Commission involving restructuring of the electric utility industry in Arizona?

A. 4. Yes. Energy Services has actively participated in this Commission's retail electric competition proceedings since it issued the initial rules in December-1996 and has attended and submitted comments in several of the Commission-established working groups, including the three subcommittees on stranded costs. I have personally testified before this Commission in its proceedings on stranded costs and in support of Energy Services application for a Certificate of Convenience and Necessity (CC&N) as an Electric Service Provider. Energy Services received the first statewide CC&N issued by this Commission for competitive energy services in late 1998.

1 Q. 5. Are you concerned with the proposed basis for valuation of the assets to be
2 transferred to APS's unregulated affiliates?

3 A. 5. Yes, I am- APS is proposing to transfer its generation and certain other (unspecified)
4 competitive services assets to its affiliate(s) at depreciated book rather than at fair market
5 value. Under traditional transfer pricing principles, the appropriate transfer price for such
6 assets must be the higher of depreciated book cost or fair market value. APS should be
7 required to transfer its competitive assets to its affiliate(s) at the higher of depreciated
8 book or fair market value¹. All recent sales of utility non-nuclear generation assets of
9 which I am aware have resulted in sale prices well in excess of the depreciated book
10 value of the assets, often several times higher. On such occasions, the utilities have been
11 able to credit to their ratepayers the premium over book value, enabling them to buy
12 down their stranded costs. APS's ratepayers will be subsidizing APS shareholders if
13 these assets are transferred to APS's unregulated affiliate(s) at below-market value.

14 Q. 6. Do you know what value Tucson Electric Power (TEP) will use to transfer
15 generation assets to its affiliate?
16

17 A. 6. Yes, I do. Tucson Electric Power's proposed settlement recently filed with this
18 Commission provides that TEP will transfer its generation and other assets deemed to be
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23 ¹ One of the generation assets APS proposes to transfer is Palo Verde Nuclear Generating Station. It is certainly
24 possible, if not probable, that Palo Verde, as a nuclear plant, may not obtain a sale price in excess of its
25 depreciated book value. In that case, the transfer of this asset should be at depreciated book value, consistent with
26 the principle that asset transfers from a utility to its affiliate must be at the higher of book value or fair market
27 value.
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competitive to a subsidiary at fair market value. We believe that is the appropriate basis for valuation.

Q.7. What impact do transfers of assets to competitive affiliates have on competitive markets?

A.7. In this particular situation there are two aspects to the proposed transfer of assets which need to be considered, and each would have a profound effect on competition in the retail electric market in Arizona. First, according to the RDI Powerdat database, APS currently owns approximately 38% of all the summer capacity in the WSCC's Arizona - New Mexico power area. If an APS affiliate receives all of APS's generation, the affiliate will immediately acquire a commanding position in the market, providing it with the ability to dominate unfairly the retail market through strategic pricing. This is because unaffiliated competitors must build or acquire their own competitive assets at fair market value, and recover the costs of those assets from the revenues generated as a result of the sales of their services or output at market prices. If APS's affiliates have incurred lower costs by obtaining assets at below-market prices, as has been proposed, they will be able to sell their products and services at a lower price than will unaffiliated competitors. This will result in the affiliates having a huge competitive advantage since the sale of electric commodity is notoriously low-margin.

The term competitive assets includes both generation and infrastructure such as customer information systems, billing, metering, and so on. Even if APS's power plants were

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excluded from the transfer, transferring the remaining infrastructure at the lower of depreciated book or fair market value still provides the affiliate an unfair advantage. The transfer of assets to competitive affiliates at below-market prices is also unfair to regulated ratepayers of APS because they will not be credited with the full value of the assets that could be realized in the marketplace, and will pay more in stranded costs than they should. The result is that APS's ratepayers will subsidize APS's competitive activities.

Therefore, transfers of assets to competitive affiliates at below-market prices will adversely impact APS's ratepayers and competition. Only APS's shareholders will benefit from such transfer, since they will receive the benefit of the unfair competitive advantage enjoyed by APS's unregulated affiliates.

Q. 8. Do you have any other concerns about APS's proposed transfer of assets to its unregulated affiliates?

A. 8. Yes, I do. APS's settlement proposal is quite vague in providing a detailed accounting of the assets to be transferred to its unregulated affiliate(s), what their value is and how the affiliates will pay for these assets. Article 4.2 of the settlement grants APS or its parent the right to create new corporate affiliates to provide competitive services, including generation sales and power marketing. It also grants APS the right to transfer generation and competitive services assets to these affiliates. To assess fully the implications of APS's settlement proposal, we need a much more detailed definition of what is being

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transferred to APS's affiliates. Exhibit C provides only a cursory list of the possible generation assets that might be transferred to its affiliate. The settlement refers to the transfer of competitive services assets, but does not adequately define these assets, nor does Exhibit C provide a list of the competitive assets APS intends to transfer to its affiliate(s).

The Commission should require APS to provide a detailed accounting, schedule and method for determining the market value of these assets to permit this settlement to be analyzed. The determination of an asset's fair market value should be accomplished through either an auction or an independent, Commission-approved appraisal process. APS's settlement is silent on these critical matters.

Q.9. Do you see any problem with APS's request that it be granted until December 31, 2002 to complete the transfer of its competitive services assets to its competitive affiliates?

A.9. APA doesn't say whether it wants to engage in unregulated competitive activities prior to the separation of these assets and, if so, how it will carry out those activities. Energy Services is strongly opposed to APS's conducting any competitive activities out of the utility. Instead, we urge that all competitive activities must be carried out by affiliates that are structurally, organizationally, functionally, operationally and financially separate from the utility, and that the utility be permitted to carry out only regulated, tariffed activities. Energy Services recommends that this Commission approve APS's request for

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an extension of the time to separate these assets only on the condition that APS be prohibited from engaging in any competitive activities through the utility structure.

Q.10. What problems do you see with the proposed method of dealing with Stranded Costs?

A.10. Under the terms of the settlement APS shall have the opportunity to collect stranded costs through a competitive transition charge (CTC). Such CTC shall remain in effect until December 31, 2004. At that time an adjustment will be made to reflect any excess recovery/under recovery. A more desirable method is the use of a tracking account. By using a tracking account, cost recovery can be tracked and the recovery period would end once stranded costs are fully recovered. If this Commission requires that all asset transfers must be priced at fair market value, it is likely that stranded costs would be recovered prior to 2004. I say this because I assume that APS would not knowingly set a termination date that would result in a significant under-recovery of stranded costs. Since I believe asset transfers should be priced at fair market value, revenues in excess of book would be credited to reducing stranded costs, resulting in a termination date earlier than that proposed by APS. In a competitive marketplace it is important that CTC collection end as soon as possible. There is no reason to have an artificial, administratively determined end date when it is quite easy to set up a tracking mechanism that would identify quickly when stranded costs are fully recovered.

1 **Q. 11. Do you believe this settlement will foster competition in APS's service territory?**

2 **A. 11.** No, I do not. There are several other aspects of this settlement that will in fact hinder
3 competition.

4 **Q. 12. What are these aspects?**

5 **A. 12.** There are at least four. These are (i) APS's proposed rate reductions; (ii) the
6 proposed one-year notice for returning large customers; (iii) electricity sales to APS by its
7 generating affiliate(s), and (iv) inadequate crediting of the non-commodity costs of retail
8 energy services.
9

10 **Q. 13. What will be the effect of the proposed rate reduction on competition?**

11 **A. 13.** Ironically, the effect of the rate reductions proposed by the settlement will be to deter
12 competition. The primary reason customers switch to competitive providers is to receive
13 lower prices than they can receive from their incumbent utility. If APS is able to provide
14 these rate reductions, Energy Service Providers (ESPs) will be required to lower their
15 prices even more in order to induce customers to switch from APS to a competitive
16 provider. The rate discount, which according to the settlement applies solely (i.e. 100%)
17 to the Standard Offer (contestable) rate component, makes it that much more difficult for
18 ESPs to offer a lower price than APS. This is because ESPs must recover in their price
19 the full costs of retail services and customer care, not merely the commodity cost, as well
20 as a profit. If ESPs are unable to beat the prices charged by APS, which will more than
21 likely be the case given the proposed rate reductions, customers will not switch. If
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1 customers do not switch, APS benefits as the provider of last resort, competition will not
2 develop, and customers will be deprived of meaningful choice. As a consequence, APS
3 will not have to face the discipline of competitive markets.

4 There are two important differences between APS and a competitive ESP which make
5 these reductions particularly anti-competitive. First, even if APS's assets are transferred
6 to its affiliate(s), there is no assurance that the affiliate, having received the assets at a
7 below-market cost, will not provide preferential pricing to APS. Second, APS prices are
8 set by tariffs, not contracts, and if APS is not able to get preferential pricing it can avoid
9 dire financial consequences by seeking to raise rates (settlement Article 2.8). Any ESP
10 that has met APS's discounts would likely be prevented from raising its prices under the
11 provisions of its customer contracts.

12 **Q.14. What will be the effect of the one-year advance notice proposed by APS?**

13 **A.14.** The settlement provides that customers greater than 3MW who choose a direct access
14 supplier must give APS one year's advance notice before returning to Standard Offer
15 services. We oppose this notice requirement. Energy Services strongly advocates that
16 the incumbent utility should fully exit the procurement function for larger commercial,
17 industrial and institutional customers, including as a default provider. This is necessary
18 to neutralize the inherent advantages enjoyed by the entrenched incumbent utility. APS,
19 however, does not propose to do this; instead, APS fully intends to compete as a
20 regulated utility with ESPs. For that reason, this proposal is anti-competitive because it
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1 will act as a deterrent to switching. This is exacerbated by the rate reductions promised
2 to customers.

3 A customer who is offered a price from an ESP that is only marginally lower than
4 APS's (if an ESP is even able initially to offer a lower price at all), knowing that it must
5 give at least a year's notice to return to regulated service, has little incentive to switch.
6

7 Stated simply, the rate reductions and the one-year notice requirement each impose
8 significant barriers to customer switching. The combination will surely further entrench
9 APS as the monopoly provider. Over time, customers will suffer because competition
10 will not develop and APS will not have to offer competitive pricing. Customers will not
11 have choice, and will not benefit from the innovativenesss spurred by competition.
12

13 Moreover, there is no reason why APS requires a year's notice from returning customers.

14 We agree that APS should not be at risk for higher power procurement costs imposed by
15 returning customers. But the solution is not to impose a notice requirement. It is instead
16 to flow the costs of power supply directly through to the returning customer. If large
17 customers returning to APS with little or no notice impose higher purchase power costs
18 on APS than APS would incur if it had reasonable notice (which would have enabled
19 APS to plan for such return with longer term, lower cost power purchase arrangements),
20 those higher costs should be flowed directly through to the returning customers. It is
21 appropriate that the customer experience the full impacts of its choices in a competitive
22 market. Its choice to return to the utility should be influenced by the economic
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1 consequences of that decision. Where there is no cost exposure to APS, there is no
2 reason to impose an artificial notice requirement, particularly where such a requirement
3 will deter switching in the first instance. APS's ability to flow those costs directly
4 through to provider-of-last-resort customers eliminates the need for customers to provide
5 APS any advance notice of their intent to return.
6

7 **Q.15. What are the problems presented by the proposed framework for APS's purchase of**
8 **electricity from its generating affiliate?**

9 **A.15.** The settlement calls for any electric energy APS purchases from its generating affiliate
10 (referred to as the EWG Affiliate) to be at market prices. However, the settlement also
11 states that its approval by this Commission will constitute pre-approval of all power
12 purchase transactions by APS from its generating affiliate. There would be no prudence
13 review to protect APS's regulated ratepayers and to guard against cross-subsidies. This
14 provision is unacceptable because it will eliminate all Commission oversight of power
15 purchase transactions between APS and its generating affiliate.
16

17 Electric power can be traded under a wide variety of contract terms, both on the spot
18 market and for long terms, and with many different degrees of shaping or optionality.
19 Only some of the contract structures correspond to deep, liquid markets (such as the
20 monthly unshaped Palo Verde market). Therefore it will be simple to frustrate the intent
21 of these terms by trading under contract structures for which the market is difficult to
22 determine.
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1 Competition will be impaired regardless of whether APS pays too little (i.e. under-
2 market) or too much (i.e. over-market). If APS pays under-market, APS's regulated
3 customers will enjoy the benefits of APS's below-market acquisition of power, but they
4 also will have little reason to switch. And ESPs will find it very difficult to compete.
5 On the other hand, if APS pays too much, its regulated supply customers will pay higher
6 costs and will therefore subsidize APS's competitive affiliate, giving it an unfair
7 competitive advantage. If that affiliate is also an ESP, any of APS's regulated
8 customers which are incented to switch to avoid those higher costs are likely to simply
9 migrate over to the affiliate because of the cost advantage it would enjoy as a result of
10 the preferential power sale. However, if APS cannot achieve a migration of its
11 regulated customers to its affiliate ESP through an above-market purchase of power,
12 there is little likelihood that APS will transact an above-market purchase with its
13 generating affiliate. Indeed, APS would be incented to purchase at below market prices
14 because of its plan to transfer its generating assets to its affiliates at below-market value.
15 This preferential transfer of generating assets will enable APS to buy-back power at
16 below market costs, which translates into lower power supply costs to its customers.
17 This will allow APS to impose a substantial barrier to switching.
18 Further, these purchases, through this settlement, will be pre-determined to be just and
19 reasonable. The ACC will give up its right to examine the prudence of those transactions
20 at or near the time of their occurrence. This is inappropriate and an abdication of this
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Commission's regulatory responsibilities. It is essential that so long as APS is serving a regulated procurement function, such as provider of last resort (POLR), its power procurement must be subject to prudence review. The potential for abuse is simply too high. An inaccurate purchase price will adversely impact the competitive power supply market.

Q.16. What is the problem you see with credits for the non-commodity costs of retail energy service?

A.16. We are very concerned that APS is not crediting the full costs of retail services that it is no longer providing to direct access customers, and is instead inappropriately recovering these costs in its distribution rates. For example, APS proposes a billing credit of only 30 cents less than the cost of a first class stamp when an ESP provides consolidated billing. This credit is unlikely to represent even the decremental cost of the bill not sent (which necessarily must be greater than the cost of first class postage), much less the fully allocated cost of the billing and collection infrastructure.

The distribution rate for direct access service should be lower than the corresponding components of the bundled retail rate because APS will no longer be incurring certain non-commodity costs of retail electric service. These non-commodity retail service costs include, for example, (i) the risks of managing and serving retail load, (ii) costs of shaping and following retail load, and (iii) various customer care costs, such as load forecasting/profiling, office overheads, customer services, metering, billing and

1 collection, bad debts, sales and marketing. Although these are undeniable costs of retail
2 electric service, under traditional rate design and regulation they have not been recovered
3 in the commodity portion of the regulated bundled rate. Instead, these non-commodity
4 costs of retail service are typically buried in the distribution function, and recovered in
5 the distribution portion of the bundled rate. For example, if the retail energy credit is
6 based only on visible wholesale price signals and ignores other cost components of retail
7 electric supply, the generation credit will be too low. The settlement will permit APS to
8 recover these costs in its distribution rates, which will be paid by all customers, both
9 standard offer and direct access.
10

11 Direct access customers, however, will pay for these retail services twice, once to APS in
12 the distribution rate and again to the ESP. This is because the ESP, which must build and
13 administer its own customer care function, in all likelihood, will be unable to price its
14 energy services at a price low enough to induce customers to switch from APS yet still
15 recover its costs of retail customer services and make a profit. As a consequence, we
16 urge the Commission to require APS to use a cost-causation approach in developing its
17 distribution rate, under which APS would identify specifically only those cost
18 components relevant to distribution service and create a pure wires-only rate. This way,
19 APS would charge only for services actually provided to customers and ESPs, and would
20 not charge i.e. credit for services avoided. Energy Services supports recovery in the
21 transition charge of any legitimate, verifiable and non-mitigable stranded retail service
22 costs.
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Q. 17. Does this conclude your testimony?

A.17. Yes.

QUALIFICATIONS OF DOUGLAS A. OGLESBY

DOUGLAS A. OGLESBY
Vice President and General Counsel
PG&E Energy Services

As chief legal officer, Mr. Oglesby is responsible for all the Company's legal matters. He is also responsible for the Company's governmental and regulatory affairs, including the advocacy of energy policy issues, particularly legislative and regulatory policies concerning industry restructuring. He is a member of the Company's Executive Committee.

Mr. Oglesby has over 20 years of legal experience in energy law and the utility industry. Mr. Oglesby came to PG&E Energy Services from a major international law firm where he was a partner in the firm's energy practice group. As a member of the firm, he represented large energy consumers, domestic and international independent power developers, power marketers and utilities on a wide range of energy issues.

Prior to private practice, Mr. Oglesby was an attorney in the law department of Pacific Gas and Electric Company, where for many years he served as Chief Counsel of the utility's Electric Supply Business Unit. As Chief Counsel he was the principal legal advisor to the Business Unit's general manager and to the utility's senior management on electric supply matters, and was responsible for all legal services required by the Business Unit, principally relating to electric resource planning, industry structure and restructuring, power plant fuel supply, bulk power, utility interchange, transmission and non-utility power transactions and associated pricing and rate issues.

Mr. Oglesby's practice has focused primarily on energy transactional matters, including complex energy alliance agreements, energy services and management agreements, power supply contracts and transmission arrangements, and on issues related to electric industry restructuring. He has practiced extensively before the Federal Energy Regulatory Commission, the California Public Utilities Commission, the California Energy Commission, and other state and federal agencies on a wide range of energy-related issues, including utility rates. He has counseled extensively on removing barriers to transactions between energy consumers and suppliers. For the last several years he has been actively involved in industry structure legislative and regulatory policy issues, including advocacy at both the state and federal levels on important energy services restructuring and competitive energy market issues, and has testified at various state regulatory and legislative hearings. Among other accomplishments, Mr. Oglesby personally participated in the development of the 1992 National Energy Policy Act and helped shape that Act's provisions relating to independent power development and electric transmission. He has participated in numerous conferences and seminars as a speaker and panelist on energy policy issues.

Mr. Oglesby obtained his law degree with highest honors from Boalt Hall School of Law, University of California, Berkeley and his B.S. from Oregon State University, Corvallis, Oregon, in General Science. He is also a graduate of the Harvard Business School Program for Management Development.

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1
3 DIRECT TESTIMONY

5 OF

7 KENNETH R. SALINE

9 (Docket No. RE-00000C-94-0165; formerly U-0000-94-165)

11 I. INTRODUCTION

13 Q. PLEASE STATE YOUR NAME, EMPLOYMENT AND BUSINESS ADDRESS.

15 A. My name is Kenneth R. Saline, and my business address is 160
17 North Pasadena, Suite 101, Mesa, Arizona 85201-6764. I am a
19 Partner of K. R. Saline & Associates, a consulting engineering
21 firm which advises members of the Arizona Transmission Dependent
23 Utility Group¹ ("TDU Group") on electrical power supply and
25 delivery matters.

27 Q. WHAT ARE YOUR QUALIFICATIONS TO TESTIFY AS AN EXPERT WITNESS?

29 A. My educational, professional qualifications and experience are
31 set forth in Attachment 1, which is attached to my testimony.
33

35 Q. HAVE YOU RECENTLY PARTICIPATED IN ANY RATE PROCEEDINGS INVOLVING
37 ANY OF THE AFFECTED UTILITIES?

39
41
43 ¹Aguila Irrigation District, Ak-Chin Indian Community, Buckeye Water
45 Conservation and Drainage District, Central Arizona Water Conservation
47 District, Electrical District No. 3, Electrical District No. 4, Electrical
49 District No. 5, Electrical District No. 7, Electrical District No. 8,
Harquahala Valley Power District, Maricopa County Municipal Water District
No. 1, McMullen Valley Water Conservation and Drainage District, Roosevelt
Irrigation District, City of Safford, Tonopah Irrigation District, Wellton-
Mohawk Irrigation and Drainage District

1 A. Yes. I have been participating as a consulting engineer and
3 witness in proceedings before the Federal Energy Regulatory
5 Commission involving the Open Access Tariff filings by Arizona
7 Public Service Company.

9 Q. **WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?**

11 A. The purpose of this testimony is to respond to the nine questions
13 put forward by the Arizona Corporation Commission concerning the
15 Commission rules on recovery of stranded costs.
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1 II. SUMMARY

3 Q. WOULD YOU SUMMARIZE THE TDU GROUP'S INTEREST IN THE ISSUES
5 IDENTIFIED IN THE DECEMBER PROCEDURAL ORDERS?

7 A Yes. The TDU Group represents utilities which are public
9 utilities created among other things to provide electrical
11 service to their loads and resale customers. The standard
13 typically adopted for serving their consumers is to provide
15 service to their consumers at the lowest possible cost consistent
17 with sound business principles. These utilities are wholesale
19 utilities and are not Affected Utilities as defined in A.A.C.
21 R14-2-1601. However, the issues related to Stranded costs may
23 impact the TDU Group utilities and their customers if stranded
25 costs are not directly quantified and assigned to the departing
27 consumer (i.e., directly assigned).

29 Socialization of stranded power costs through broader-based
31 charges such as facility charges, distribution wheeling rates,
33 ancillary service rates, meter charges, or across other related
35 services will result in cost shifting to the non-departing
37 consumers, other utilities or consumers of other utilities.
39 Since the TDU Group members also wheel power across the
41 integrated transmission and distribution systems of Affected
43 Utilities, collection of stranded power supply costs through wire
45 service charges or connection fees will shift stranded costs to
47 consumers who have their own power cost responsibilities and are
49 not responsible for creating a stranded power cost to the

1 Affected Utility. Consumers may also depart from a TDU Group
3 utility to another supplier which may strand a power supply cost
5 of the respective TDU Group utility.

7 Because of the potential for cost-shifting and causation by the
9 departing customer, I recommend the Commission require specific
11 quantification of Stranded Costs for each departing customer on a
13 direct assignment basis. Consistent with FERC Order 888, if a
15 customer uses retail access to reach a new supplier, the utility
17 should be entitled to recover legitimate, prudent and verifiable
19 costs that it incurred. Direct assignment of stranded costs to
21 the departing consumer is preferable because the stranded costs
23 are caused by the departing customer.

25 From an end-use customer standpoint, stranded costs will have to
27 be weighed against the savings realized by accelerated access to
29 market suppliers. Due to the economics and unresolved technical
31 factors, like the independent transmission system operator, the
33 larger customers have the greatest potential for justifying
35 paying stranded costs, and should be allowed to do so. Metering,
37 accounting, billing, and resource administration services must
39 still be resolved on a large scale, without creating an
41 independent source of costs which outweighs potential power
43 supply savings. If market prices go up between now and 2003, the
45 potential for stranded costs will be reduced. If market prices
47 go down, customers may be able to afford to pay their stranded
49 costs and save money. If a consumer cannot economically justify

1 leaving their power supplier, then that supplier must be the
3 lowest cost provider to that customer and the Commission Rules
5 should not create a stranded cost for that consumer or increase
7 costs to that consumer.

9 **III. RESPONSE TO EACH OF THE ISSUES IDENTIFIED IN THE DECEMBER**
11 **PROCEDURAL ORDERS?**

13 **Issue No. 1 - Should the Electric Competition Rules be modified**
15 **regarding stranded costs? If so, how?**

17
19 A. Yes.

21 Q. Do you have any specific recommendations?

23 A. I believe the Rules should be modified with regard to stranded
25 costs. Specifically, I would propose that the term "verifiable"
27 in the definition found in R14-2-1601(a) be further clarified by
29 the following addition:

31 "Verifiable means proven by the Affected Utility by clear and
33 convincing evidence".

35 Recovery of stranded costs is an extraordinary activity. The
37 Affected Utility claiming such recovery should bear a significant
39 burden of proving that these costs are actually stranded. While
41 I am not an attorney, I am advised that the "clear and convincing
43 evidence" standard is a stringent one and appropriate for this
45 type of inquiry since the stranded costs will be paid.

47
49 Q. Do you have any comment about any other suggested changes to this
definition that have been included in other testimony?

1 A. Yes, I believe it was appropriate for the Commission to terminate
3 the acquisition of costs which are included in stranded costs as
5 of the date of the Rules being ordered into effect, December 26,
7 1996. Utilities had substantial notice before then of the Rules
9 being developed and implemented. Investments made after the
11 effective date of the Rules should be considered business risks.
13 Additionally, I believe the use of the term "value" in the
15 "before" test is valid. Certainly, assets that have previously
17 been scrutinized and allowed by the Commission need no further
19 scrutiny. But assets and obligations incurred between the
21 utility's last rate case and the effective date of the Rules
23 should be subject to question.

25 Q. Do you have any other suggestions with regard to changes in the
27 Rules?

29 A. Yes. Concerning the collection of stranded costs, I believe that
31 the Commission should retain the use of the term "feasible" in
33 R14-2-1607 and not accept the suggestions that have been made
35 about changing that term to "reasonable". The existing term is
37 an action-forcing mechanism. Changing to some reasonableness
39 standard only provides a wider range of excuses not to do
41 something. I believe that mitigation should apply to all
43 activities of an Affected Utility that can provide a source of
45 revenue, even if such activities are unregulated. Furthermore,
47 as unbundled rates become the norm, some activities currently
49 undertaken under bundled rates, such as metering and billing, may
end up being unregulated activities. I think utilities should

1 have the opportunity to mitigate costs by any legitimate means at
3 their disposal without reaching into the activities of holding
5 companies or sister corporations under such holding companies.

7 In addition, it is obvious that paragraphs C., D., E., and F.
9 will need to be stricken at some point in time because they
11 define tasks that have been accomplished. I would recommend that
13 a new paragraph C. be added to state a burden of proof as to
15 mitigation as follows:

17 "The Affected Utility shall be required to show by clear and
19 convincing evidence that all feasible, cost-effective
21 mitigation measures have been employed".

23 Q. Do you have any other suggestions about these Rules?
25

27 A Yes. The more testimony I read and the more debate we have over
29 stranded costs, the messier the subject becomes. The larger
31 Affected Utilities appear to believe that they can adjust to the
33 new economic conditions within the next five to seven years.
35 Utilities are already underway to restructuring services and
37 costs to their larger customers. Wouldn't the Commission,
39 utility customers and indeed the companies themselves be better
41 off if the Commission allocated more time to make business
43 decisions, and resolve technical issues and just not deal with
45 this subject? We have already seen major reaction by the biggest
47 of these utilities in Arizona to the upcoming competition without
49 these rules on stranded costs. What would happen if we allowed
the largest electric consumers in Arizona to go first? Aren't

1 they the most sophisticated and don't they have the greatest
3 potential to pay stranded costs? We could then let the next
5 largest group follow and finally get to the homeowners. Wouldn't
7 the companies have more time to make business judgments, inform
9 consumers and spend less time talking to lawyers this way? We
11 might even be able to keep the same tight time table in the Rule
13 (R14-2-1604).

15 Issue No. 2 - When should "Affected Utilities" be required to make a
17 "stranded cost" filing pursuant to ACC R14-2-1607?

19 Q. Do you have an opinion with regard to the above question?

21 A. The Commission needs to set a timetable for stranded cost filings
23 that will allow it to make its determinations about stranded
25 costs being "verifiable" and "unmitigated" before such costs are
27 collected. The amount of time the Commission needs to do this
29 should be the lead time necessary for the filing.

31 Issue No. 3 (pursuant to Procedure Order dated 12/1/97) - What costs
33 should be included as part of "stranded costs" and how should those
35 costs be calculated?

39 Issue No. 3 (pursuant to First Amended Procedural Order) - The
41 recommended calculation methodology and assumptions made
43 including any determination of the market clearing price.

45 Q. What costs should be included as part of stranded costs?

47 A. Generation costs should be included as long as the assets were
49 acquired or the obligations incurred before the effective date of
these Rules. Any financial obligations after that should be

1 consigned to business risk. Generation costs already allowed in
3 the rate base need not be reexamined but costs and obligations
5 incurred in the interim between the utility's last rate case and
7 the effective date of these Rules should be subject to scrutiny.

9 Q. Do you have a recommendation with regard to the methodology for
11 calculating stranded costs?

13 A I am concerned about the testimony I have read about use of lost
15 revenues approach. Comparing revenues in a regulated environment
17 to revenues in an unregulated environment will be difficult. In
19 the former, there is a regulatory decision allowing a rate of
21 return on assets whose value has been determined and approved for
23 inclusion in a rate base. In the unregulated market, business
25 practice and competition will determine rates of return or profit
27 margins. The new margins may be more or less than such rates of
29 return in a regulated environment. The industry itself will set
31 these practices based on competition. At least in the interim,
33 resource margins are likely to become much tighter. Thus, the
35 utility should have to demonstrate that it has an asset that it
37 is not able to use or a cost that is not recoverable. This would
39 avoid the situation where the utility decides to lower prices and
41 therefore net revenues for competitive purposes and then turns
43 around and claims stranded costs because of such deliberately
45 lowered rates.

47 Issue No. 3 (pursuant to First Amended Procedure Order) - The
49 implications of the Statement of Financial Accounting Standards

1 No. 71 resulting from the recommended stranded cost calculation
3 and recovery methodology.

5 Q. Do you have an opinion about the implications of Statement of
7 Financial Accounting Standards No. 71?

9 A. No. I am not an accountant.

11 Issue No. 4 - Should there be a limitation on the time frame over
13 which "stranded costs" are calculated?
15

17 Q. Do you have a suggestion for a time limitation on the stranded
19 cost calculation methodology?

21 A. Yes. The purpose of retail access is to transform the regulated
23 power supplies to unregulated power supplies. Therefore, any
25 protracted stranded costs recovery will only delay the ultimate
27 transition to unregulated supplies, and create excessive
29 administrative costs. Either through payment of stranded cost
31 for a departing customer, or expiration of the period for
33 accessing stranded costs, stranded costs must have finality. The
35 stranded cost methodology should be used to provide a transition
37 and not to provide security for utility assets through the
39 remainder of their useful life. I believe that the time frame
41 should be set to cover a period of "regulatory upset". At the
43 very latest, that period should end at the end of 2006. Economic
45 adjustments after the fixed date should be a matter of business
47 risk. Otherwise the utility will take profits in good years and
49 cover losses through stranded costs in bad years, getting the
best of the regulated monopoly and unregulated worlds, but not

1 leaving much for the consumer.

3 Issue No. 5 - Should there be a limitation on the recovery time frame
5 for "stranded costs"?

7 Q. What time limitation on stranded cost recovery do you recommend?
9

11 A. I believe the amortization period for each customer to pay their
13 stranded cost should be dependent upon the utility and customer.
15 Flexibility will be necessary for the various utilities to
17 recover stranded costs from departing customers. For example, a
19 TDU Group utility may recover stranded costs through increased
21 water payments like a transmission owner is permitted to recover
23 wholesale stranded costs through a transmission surcharge.
25 Flexibility in the amortization period will enhance the
27 opportunity for customer choice by giving customers financing
29 options for stranded cost payments.

31 Issue No. 6 - How and who should pay for "stranded costs" and who, if
33 anyone, should be excluded from paying for stranded costs?

35 Q. Who should pay for stranded costs?

37 A. Customers departing to access the competitive marketplace should
39 pay for that advantage, if stranded costs are to be collected.
41 Broad base charges or surcharges on all customers, even those
43 remaining behind with bundled service from the utility, would
45 amount to nothing more than a tax.

47 Q. How should stranded costs be collected?

49 A. I believe that exiting customers should pay a predetermined

1 stranded cost fee based on a net profit formula calculated over a
3 four to seven year period as determined by the Commission. The
5 proceeds would be deposited in a fund with interest and paid to
7 the Affected Utility upon successful proof that it had incurred
9 stranded costs under these Rules. The stranded cost fee would be
11 charged only the first time a customer transferred from current
13 regulatory service to competitive service. Collection of the
15 stranded cost fee could be staged over a longer collection
17 period as long as the customer remained in Arizona and received
19 service from an Affected Utility.

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

25 Q. Do you recommend the establishment of a true-up mechanism?

27 A. I don't believe a continuous true-up mechanism would be necessary
29 if a direct assignment method and refund is employed. The
31 Commission would set a formula that determined a fixed amount of
33 money as a one-time amount or staged fee for entering
35 competition. The money could be collected into a fund subject to
37 refund to the customer if the utility failed to demonstrate that
39 it incurs its claimed stranded costs. Since real money would be
41 involved in real dollar decisions, no "true-up" would be
43 necessary once the cost is proven. The proof requirements of
45 the utility would take care of that.

1 Issue No. 8 - Should there be price caps or a rate freeze imposed as
3 part of the development of a stranded costs recovery program, and if
5 so, how should it be calculated?

7 Q. Do you recommend price caps or a rate freeze?

9 A. No. The idea is to deregulate prices and market forces should be
11 allowed to work.

13 Issue No. 9 - What factors should be considered for "mitigation" of
15 stranded costs?
17

19 Q. What limits should the Commission make to mitigation activities?

21 A. The Commission should not limit any Affected Utility in efforts
23 it might make to mitigate stranded costs. These would include
25 both regulated and unregulated activities that the utility may
27 undertake under State law. Since some bundled activities may end
29 up unregulated when unbundled, the concept of "traditional"
31 utility activities may have little relevance in the future.

33 Q. **HAVE YOU PRIORITIZED THE ISSUES ADDRESSED IN YOUR TESTIMONY AS**
35 **REQUESTED BY THE DECEMBER PROCEDURAL ORDERS?**

37 A. No, I have followed the order of the questions. Because of the
39 interdependence of the subjects covered, relative priority is
41 difficult to assess. Since the purpose of this process is to
43 consider Rules amendments, that is obviously the first priority.

45 Q. **DO YOU HAVE ANY OTHER OBSERVATIONS ABOUT THESE RULES RELATED TO**
47 **STRANDED COSTS?**

49 A. Yes. Without finality, stranded costs will be headed toward a

1 process that could be more complicated and time-consuming than
3 current rate cases. We would then be merely substituting one
5 form of regulation and costs for another, not deregulating the
7 sale of electricity or decreasing the price of electricity at
9 retail in Arizona. There ought to be a better way of doing this.

11 Q. DOES THAT CONCLUDE YOUR TESTIMONY?

13 A. Yes. It does.
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STATEMENT OF QUALIFICATIONS

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Kenneth R. Saline is the principal partner in K.R. Saline & Associates, a consulting engineering firm located in Arizona. Mr. Saline provides electrical power consulting services to numerous irrigation districts, electrical districts, federal, state and municipal utilities located in Arizona, New Mexico and Nevada. Mr. Saline is a registered professional electrical engineer in the State of Arizona.

Mr. Saline graduated from New Mexico State University in 1980 with a Bachelor of Science degree in Electrical Engineering with power system emphasis. Mr. Saline worked for four years at San Antonio Public Service Company, a municipal electric and gas utility, as a transmission planning engineer. At San Antonio, Mr. Saline performed planning studies of the city's transmission systems including interconnected EHV transmission and stability studies in various Electric Reliability Counsel of Texas (ERCOT) committees. Mr. Saline represented the city in the ERCOT Engineering Subcommittee, Loadflow Task Force, EHV Task Force, Power Transfer Task Force and Transient Stability Task Force. During this period, these ERCOT task forces established the wholesale power brokerage system, Megawatt-mile transmission wheeling methodology, and the first transient stability analysis of the interconnected ERCOT EHV system.

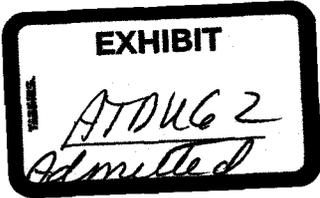
Following San Antonio, Mr. Saline worked for R.W. Beck and Associates for seven years as an engineering consultant. At R. W. Beck, Mr. Saline assisted public utilities in applying for allocations of Hoover power, Salt Lake City Integrated Projects power, and Parker-Davis Project power. He participated in the preparation of Consulting Engineer's Reports used in Official Statements issued for revenue bond financing and assisted in the start-up of five new municipal utilities who were established to utilize Hoover power entitlements in Arizona. He assisted these utilities in wholesale power supply and wheeling contract negotiations, power supply planning and development of customer policies, rates and regulations for service to their customers.

Currently Mr. Saline provides ongoing consulting engineering services and management consulting to various public utility clients within Arizona with regard to their long-term and short-term electric operations. In this capacity he is responsible for power scheduling, economic studies, power supply studies, transmission studies, rate analyses, contract negotiations and customer service policies. His representation of these entities includes recommendations to federal and state agencies and he negotiates necessary programs, contracts and policies on their behalf.

SUMMARY OF TESTIMONY OF KENNETH R. SALINE

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1. The Rules should be changed to clarify the standard of proof for stranded costs.
2. Costs incurred or obligated prior to December 26, 1996 should be included in stranded costs.
3. Direct proof of a stranded asset should be required.
4. Stranded costs should be calculated over a period of regulatory upset, but not beyond 2006.
5. Stranded cost recovery periods should be flexible.
6. Customers availing themselves of retail competition should pay stranded costs.
7. No true-up mechanism is necessary if direct assignment of costs is used.
8. There should be no price caps or rate freezes.
9. All utility activities should be usable for mitigation.





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BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK
CHAIRMAN
JAMES M. IRVIN
COMMISSIONER
BILL MUNDELL
COMMISSIONER

IN THE MATTER OF THE APPLICATION OF ARIZONA
PUBLIC SERVICE COMPANY FOR APPROVAL OF ITS
PLAN FOR STRANDED COST RECOVERY.

DOCKET NO.
E-01345A-98-0473

IN THE MATTER OF THE FILING OF ARIZONA PUBLIC
SERVICE COMPANY OF UNBUNDLED TARIFFS
PURSUANT TO A.A.C. R14-2-1601 ET SEQ.

DOCKET NO.
E-01345A-97-0773

NOTICE OF FILING

The Arizona Utility Investors Association hereby
provides notice of filing Direct Testimony as required by the
Commission's procedural order in the above-captioned matter.

DATED THIS 29TH DAY OF JUNE, 1999.

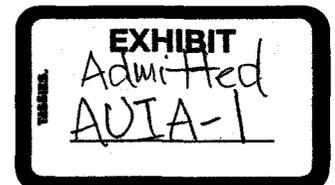
WALTER W. MEEK, PRESIDENT

Original and ten (10) copies of the
referenced Testimony were filed this
29th day of June, 1999, with:

Docket Control
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Copies of the referenced Testimony
were hand-delivered this 29th day of
June, 1999, to:

Chairman Carl J. Kunasek
Commissioner Jim Irvin
Commissioner Bill Mundell
Paul M. Bullis, Legal Division
Ray Williamson, Utilities Division
Jerry Rudibaugh, Hearing Division
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Copies of the referenced Testimony
were mailed this 29th day of June, 1999,
to the following parties of record in the
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BEFORE THE
ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION
OF ARIZONA PUBLIC SERVICE COMPANY
FOR APPROVAL OF ITS PLAN FOR
STRANDED COST RECOVERY

DOCKET NO. E-01345A-98-0473

IN THE MATTER OF THE FILING OF
ARIZONA PUBLIC SERVICE COMPANY
OF UNBUNDLED TARIFFS PURSUANT
TO A.A.C. R14-2-1601 *ET SEQ.*

DOCKET NO. E-01345A-97-0773

DIRECT TESTIMONY OF
WALTER W. MEEK

ON BEHALF OF
THE ARIZONA UTILITY INVESTORS ASSOCIATION

JUNE 28, 1999

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DIRECT TESTIMONY

OF

WALTER W. MEEK

L. Introduction

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Walter W. Meek. My business address is 2100 North Central Avenue, Suite 210, Phoenix, Arizona 85004.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am the president of the Arizona Utility Investors Association ("AUIA" or "Association"), a non-profit organization formed to represent the interests of shareholders and bondholders who are invested in utility companies based in or doing business in the state of Arizona.

Q. ARE SOME AUIA MEMBERS SHAREHOLDERS OF ARIZONA PUBLIC SERVICE COMPANY?

A. In a manner of speaking, yes. AUIA has approximately 6,000 members and a substantial percentage are common shareholders of Pinnacle West Capital Corporation. APS is the principal subsidiary of Pinnacle West.

Q. WHAT IS YOUR BACKGROUND IN REPRESENTING SHAREHOLDER CONCERNS AND INTERESTS?

A. I have been president of AUIA for five years. Prior to that, my consulting firm managed the affairs of the Pinnacle West Shareholders Association for 13 years. During these periods we have represented shareholders in numerous rate cases and other regulatory matters and have published many position papers, newsletters and other documents in support of shareholder interests.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I am here to represent the views of the equity owners of Pinnacle West on stranded costs and related issues which are addressed in the proposed Settlement Agreement.

1 I should point out that the equity owners are the only parties to this
2 proceeding whose property and personal savings are at risk.
3

4 Q. WHAT HAS BEEN YOUR INVOLVEMENT IN THE COMMISSION'S
5 ATTEMPT TO BRING RETAIL COMPETITION TO THE ELECTRIC
6 INDUSTRY IN ARIZONA?

7 A. I have grown old with this issue. AUIA has been an active intervenor
8 and participant in deregulation since the Commission opened this
9 docket in 1994. We participated in the original rulemaking which ended
10 in December 1996. We participated in five working groups that
11 attempted to reach consensus on unresolved issues during 1997. We
12 took part in the generic stranded cost proceedings in 1998, the subsequent
13 rulemaking efforts in 1998 and 1999, and a variety of ancillary issues and
14 proceedings in between. In 1998, we intervened in Salt River Project's
15 rulemaking and ratesetting proceedings in response to the state Electric
16 Competition Act. We have been active in the formation of the Arizona
17 Independent Scheduling Administrator (AISA) and continue to work on
18 the formation of the Desert STAR independent system operator (ISO).
19

20 II. The Significance of Stranded Cost

21

22 Q. WHY IS THE STRANDED COST ISSUE IMPORTANT?

23 A. There is both a legal and an ethical dimension to that question.
24

25 The legal importance is that the exclusive service franchises granted to
26 Arizona utilities, which are represented by their certificates of
27 convenience and necessity (CC&Ns), cannot be revoked or altered to
28 permit competition until they are compensated for any damages they
29 suffer due to those changes. The Commission's most recent order
30 regarding stranded cost recovery affirms this fact.
31

32 The ethical response is that the state also has a moral obligation to live
33 up to the promise inherent in utility regulation that investors will be
34 granted a realistic opportunity to recover prudently made investments
35 along with a reasonable rate of return on those investments.

1 Q. ARE THERE MISUNDERSTANDINGS ABOUT STRANDED COST?

2 A. Those who want to avoid paying stranded cost commonly describe it as a
3 payoff to utilities for poor decisions in building "inefficient" or
4 "uneconomic" generating plants that can't compete in an open market.
5 This is a convenient historical distortion and disinformation that serves
6 to muddy the issues.

7
8 Q. CAN YOU PROVIDE AN EXAMPLE OF THIS DISINFORMATION?

9 A. Yes. The Palo Verde Nuclear Generating Station is repeatedly cited as an
10 example of an uneconomic generating asset. But in terms of both
11 construction and operation, this is wrong. A \$40 million prudence audit
12 by this Commission concluded that Palo Verde's construction was well
13 managed. Furthermore, Palo Verde's low operating costs make it the
14 most efficient baseload generating plant in the southwest.

15
16 Q. THEN WHAT IS STRANDED COST?

17 A. We are talking primarily about fixed costs, the sunk costs to build and
18 finance generating facilities which are still unamortized. Regulation has
19 suppressed rates by stretching cost repayment and the allowed return to
20 investors over the life of the assets. Stranded costs would also include
21 long term contracts for purchased power and fuel supplies that are above
22 market prices and regulatory assets that haven't yet been recovered.

23
24 Q. HOW DOES THE PALO VERDE EXAMPLE APPLY HERE?

25 A. The prudence audit concluded that Palo Verde's construction costs
26 weren't out of line. Nevertheless, it was expensive to build and has
27 relatively high fixed costs. The tradeoff is low operating cost. The fixed
28 costs were meant to be recovered through regulated rates over the life of
29 the plant -- 40 years. Some portion of Palo Verde's fixed costs will not be
30 recoverable with unregulated prices because today there are facilities that
31 will sell surplus generation into the market at marginal cost.

1 Q. WHO IS RESPONSIBLE FOR PAYING FOR STRANDED COST?
2 A. There has never been any question that utility fixed costs, including a
3 reasonable rate of return, would be recovered in customer charges. If
4 there had been any doubt about cost recovery, no one would have
5 invested to pay for these facilities, at least not at regulated rates of return.
6

7 Q. WHO SUFFERS IF STRANDED COST RECOVERY IS NOT ALLOWED?
8 A. Hundreds of thousands of people who, either directly as shareholders or
9 indirectly as pension fund contributors, purchased stock in Arizona
10 utility companies. Every dollar of stranded cost that is not recovered
11 will reduce the value of investments which are depended upon by
12 retired people and the pension funds of teachers, firemen and other
13 working people. In addition, the state of Arizona would suffer if utility
14 finances were undermined to the point that they couldn't pay for the
15 infrastructure needed to support economic development.
16

17 Q. WHO OR WHAT CAUSED STRANDED COST?
18 A. Stranded costs are the product of the transition from a regulated retail
19 power market to a competitive one, but past regulatory policies and
20 decisions are the actual source of stranded cost. I could provide
21 numerous examples to show that virtually every dollar of stranded cost
22 can be traced to regulatory policies and decisions.
23

24 The point is, however, that utility customers have always been
25 responsible for repaying prudently incurred costs in regulated rates.
26 Since the Commission is changing the rules of the marketplace, it must
27 provide a substitute recovery method.
28

29 **III. Overview of the Settlement Agreement**
30

31 Q. IN GENERAL, DOES AUIA FAVOR A NEGOTIATED SETTLEMENT OF
32 STRANDED COST AND RELATED ISSUES?
33 A. Yes. AUIA has advocated resolving these issues through negotiated
34 agreements since the Commission's generic hearings on stranded cost
35 were held in February 1998.

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Q. WHY?

A. There are several advantages to negotiated agreements, but I will cite two. First, it was obvious in the generic hearings that every company's financial situation is different and that each utility requires an individualized approach to stranded cost recovery. This reality points toward negotiated settlements in the more complex cases.

Second, a contested stranded cost order is not likely to satisfy anybody completely, including the utility company. If a utility can't accept the result, the probable consequence would be a protracted period of litigation which would seriously complicate and delay the onset of retail competition.

Q. IS THIS THE FIRST PROPOSED SETTLEMENT OF APS' STRANDED COST CLAIMS?

A. No, it is the second. A previous Settlement was offered last November.

Q. ARE THERE DIFFERENCES BETWEEN THEM?

A. Yes. There are major technical differences in the methods of determining stranded costs and in the impacts on shareholders and consumers. There are also significant political differences.

Q. WHAT DO YOU MEAN BY POLITICAL DIFFERENCES?

A. Simply that the parties to the agreements are very different. The 1998 Agreement was negotiated solely between Commission staff at that time and APS. The current Agreement was negotiated between APS and key consumer groups that have been parties to these proceedings.

Q. WHICH AGREEMENT DO YOU PREFER?

A. From a shareholder's perspective, both have their good and bad points. I wasn't completely supportive of the first Settlement and I don't have unbridled enthusiasm for this one. From a political perspective however, it seems that an agreement that is endorsed by large and small consumers should carry more weight with the Commission than one that has only the staff's approval.

1 Q. WAS AUIA A PARTY TO THIS AGREEMENT?

2 A. No, we were not.

3

4 Q. WERE YOU ASKED TO ENDORSE IT?

5 A. No.

6

7 Q. DO YOU ENDORSE IT NOW?

8 A. Yes, but with very serious reservations.

9

10 Q. WHAT ARE YOUR RESERVATIONS?

11 A. This Agreement is not fair to shareholders. AUIA and APS have argued
12 consistently in these proceedings that shareholders should have a
13 reasonable opportunity -- not a guarantee -- of recovering all of their
14 stranded costs. This Agreement does not provide that opportunity.

15

16 In this instance, all of the parties agree that APS' stranded costs,
17 excluding regulatory assets, are at least \$533 million net present value
18 before income taxes. Yet, APS is required to write off 34 percent of that
19 amount -- \$183 million present value, \$234 million in nominal dollars.

20

21 Furthermore, I agree with APS' witness, Dr. John Landon, that the
22 Agreement places a significant degree of risk for recovery of stranded
23 costs and regulatory assets on the company's shareholders. I believe he
24 is right in his assessment that APS has underestimated the potential for
25 stranded costs and has accepted responsibility for more mitigation than it
26 can achieve.

27

28 Q. CAN YOU BE MORE SPECIFIC ABOUT YOUR CONCERNS?

29 A. Yes. The agreement implies that the upper limit on APS' stranded cost
30 is \$533 million, but we don't know that. If APS has misjudged the
31 impact of competition or overestimated the operating efficiencies it can
32 achieve, its stranded costs will go up. There is no mechanism for
33 recovering more than \$350 million of stranded cost.

1 Mitigation through increased operating efficiencies would be the
2 expected response to higher-than-anticipated stranded costs. But APS is
3 already exposed to \$183 million (present value) of mitigation as a result
4 of the write-off. Given the extremely high capacity factors it has forecast
5 for its power plants and the annual rate reductions called for in the
6 Agreement, it seems very unlikely that APS could accomplish much
7 more in the way of mitigation.
8

9 Finally, I am not sanguine about the recovery of regulatory assets.
10 Recovery seems assured by the terms of the Agreement, but what
11 happens if the future revenue stream, depleted by annual rate
12 reductions, is insufficient to recover regulatory assets in the time frame
13 that is allowed? There is no recovery mechanism beyond July 1, 2004.
14

15 Q. WHO BENEFITS THE MOST FROM THIS AGREEMENT?

16 A. This is a smashing deal for consumers, especially those who remain on
17 standard offer service. The rate reductions alone make this Agreement
18 far more attractive to consumers than the Settlement that was
19 negotiated last year between APS and the Commission staff.
20 Unfortunately, the rate reductions in combination with the write-off
21 amplify the shareholder's risk that I alluded to earlier.
22

23 Q. WHY DO YOU THINK APS AGREED TO THIS SETTLEMENT?

24 A. I believe the company is motivated -- with good reason -- to get the
25 deregulation process moving toward a conclusion. I suppose company
26 management concluded that this Agreement was the best deal they
27 could get under the circumstances and in a reasonable time frame.
28

29 Q. IF YOU HAVE SUCH SERIOUS RESERVATIONS, WHY DO YOU
30 ENDORSE THIS AGREEMENT?

31 A. The company and its shareholders are on the horns of a dilemma. On
32 the one hand we feel we have a moral and legal right to fair treatment by
33 the state. However, the financial markets hate uncertainty and I believe
34 we are now being penalized for the bizarre state of affairs in Arizona.

1 We have been slogging through this docket for five years. We have
2 missed one start date for retail competition. We have had three sets of
3 rules, two stranded cost orders and two Settlement Agreements in the
4 past 30 months. Even the state Supreme Court has intruded on the
5 deregulation process. Arizona has become the Bosnia of utility
6 regulation and financial analysts have grown wary of it.
7

8 I would rather absorb a one-time loss than be embroiled in conflict for
9 many months or even years. We need to get these issues behind us and
10 get on with competition. If the Agreement can achieve that objective,
11 then its benefits outweigh its deficiencies, even for stockholders.*
12

13 IV. Components of the APS Settlement Agreement 14

15 Q. LET'S PROCEED TO SOME OF THE INDIVIDUAL COMPONENTS OF
16 THE SETTLEMENT AGREEMENT. HOW DO YOU VIEW THE
17 SCHEDULE OF RATE REDUCTIONS IN THE AGREEMENT?

18 A. First, I will concede that there is a trade off in providing some rate
19 reductions while postponing a general rate case until stranded costs and
20 regulatory assets have been recovered. That trade off is of some value to
21 shareholders. That being said, I believe the rate reductions contained in
22 this Agreement are excessive and pose significant risks for shareholders.
23 For customers below 3MW, the cumulative rate reductions from 1994
24 through 2003 will total nearly 15 percent. That is 50 percent more than is
25 required of public power entities under the state's Electric Competition
26 Act and is a larger measure of rate reduction in conjunction with
27 deregulation than has been achieved in any other jurisdiction I know of.
28

29 Q. DO YOU HAVE ANY COMMENTS REGARDING THE PHASE-IN
30 PROVISIONS IN THE AGREEMENT?

31 A. As far as I can tell, these provisions mirror those in the Commission's
32 proposed electric competition rules except that APS is providing an
33 additional 140 MW of non-residential load in the first phase. Clearly,
34 the Agreement will act to accelerate retail competition.

35 * Of course, this may become known as the Neville Chamberlain theory of deregulation and
36 stranded cost recovery.

1 I might note that there is apparent confusion over the single premise, 40
2 kW limitation during the phase-in. There are differing opinions on
3 whether it applies to residential customers. If it doesn't, both the rules
4 and the Agreement should make that clear.
5

6 Q. IS THE TREATMENT OF REGULATORY ASSETS APPROPRIATE IN
7 THIS AGREEMENT?

8 A. Yes, apart from my concerns about the revenue stream. This is no
9 concession to shareholders because regulatory assets are simply a long
10 standing promisory note from the Commission. The Agreement only
11 confirms the terms of accelerated recovery which were approved by the
12 Commission in 1996.
13

14 Q. ARE YOU CONCERNED THAT THE WRITE-OFF WILL BE RECORDED
15 AS A REDUCTION IN REGULATORY ASSETS?

16 A. No. I'm not an accountant, but presumably if you're going to have a
17 write-off, it has to come from a recognized asset and a known revenue
18 stream.
19

20 Q. DO YOU HAVE ANY FURTHER COMMENTS REGARDING
21 STRANDED COST RECOVERY AND THE DISALLOWANCE?

22 A. Yes. I believe the write-off is excessive and I know of no basis for it other
23 than the fact that it is a negotiated figure. Although we believe the \$350
24 million recovery amount has been discounted too deeply, there is merit
25 in having a firm number to work with and a firm schedule for applying
26 the Competitive Transition Charge (CTC) to all classes of direct access
27 customers.
28

29 It also appears that the resulting CTC is reasonable and will not stifle
30 competition as some have feared. For residential customers, the CTC
31 will average a little more than 6 mills per kWh over the recovery period
32 and considerably less for commercial and industrial customers.

1 Q. WHAT IS YOUR OPINION OF THE FUTURE ADJUSTMENT CLAUSE?
2 A. It seems like a good idea that is fair to all parties. Since we're dealing
3 with a hard number on stranded cost recovery, as opposed to a formula
4 or a floating CTC, the adjustment clause is a reasonable way to "true up"
5 the actual collection.

6
7 The inclusion of the adjustment clause also recognizes that there
8 probably will be additional transition expenses and costs of compliance
9 with the Commission's competition rules that merit recovery
10 consideration. In particular, shareholders should not have to bear the
11 expense of being required to transfer generating assets and other
12 competitive services into a separate corporate affiliate.

13
14 Q. HOW DO THE SHAREHOLDERS VIEW THE PROVISIONS IN THE
15 AGREEMENT GOVERNING CORPORATE STRUCTURE?

16 A. In our view they are reasonable and necessary. In order for the transfer
17 of assets to proceed smoothly, the various waivers to sections of Title 40
18 of the Arizona Revised Statutes are needed, as are the Commission
19 findings which are required by the Public Utility Holding Company Act.

20
21 Q. WHAT ABOUT THE TRANSFER OF ASSETS AT BOOK VALUE?

22 A. Clearly, a book value transfer is a cleaner and less expensive way to
23 transfer generating assets than, for example, trying to determine a
24 market value. Obviously, the market value of the generating assets is
25 less than book value, a fact that is confirmed by the stranded cost
26 calculation. If APS transferred the assets at less than book value, there
27 would either have to be additional write-offs or the affiliate would have
28 to be capitalized to pay APS the difference. As it is, if APS has
29 underestimated the difference between market and book value -- that is,
30 if they have underestimated stranded cost, then the quality of the
31 company's earnings in terms of rate of return will be jeopardized.

32
33 Q. DO YOU HAVE ANY OBSERVATIONS REGARDING THE
34 COMPANY'S TARIFF FILING?

35 A. No. AUIA claims no expertise in rate design.
36

1 V. Conclusion

2
3 Q. ALTHOUGH AUIA IS NOT A PARTY TO THIS AGREEMENT, ARE
4 THERE "DROP-DEAD" PROVISIONS THAT SHOULD CAUSE APS TO
5 WALK AWAY IF THEY ARE NOT ACCEPTED BY THE COMMISSION?

6 A. There certainly are some.

7
8 First, APS should not accept any further reductions in the amount of
9 stranded cost that it is allowed to recover.

10
11 Second, no further concessions should be allowed in terms of future rate
12 reductions. The revenue risk is already too great.

13
14 Third, the future adjustment clause must be retained.

15
16 If any of these provisions were significantly altered to the company's
17 disadvantage I would expect APS to abandon the Agreement.

18
19 Q. DO YOU HAVE ANY FINAL COMMENTS?

20 A. Yes. I will repeat that this Agreement is inherently unfair to Pinnacle
21 West shareholders. However, it will bring an offsetting measure of
22 certainty to the marketplace which is important to the equity owners.
23 A few years ago, APS and its shareholders would have mounted the
24 barricades to prevent an unjust write-off of Palo Verde. Today, we are
25 giving up \$183 million of stranded cost to bring these issues to closure.
26 In accepting this Agreement, APS has moved close to the edge in its
27 fiduciary responsibility to Pinnacle West shareholders.

28
29 There is no remaining wiggle room in this Settlement Agreement.

30
31 Q. DOES THAT CONCLUDE YOUR TESTIMONY?

32 A. Yes, it does.