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**BEFORE THE
ARIZONA CORPORATION COMMISSION**

DOCKET NO. U-0000-94-165

TESTIMONY OF TOM BRODERICK

On Behalf of

THE ARIZONA SCHOOL BOARDS ASSOCIATION, INC.

January 21, 1998

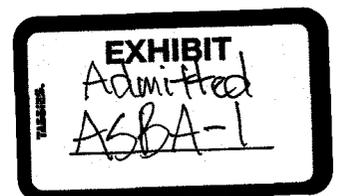


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1 **Q. Please explain why a representative of Energy Services, a prospective new**
2 **entrant electric services provider in Arizona, is presenting testimony on behalf**
3 **of an entity such as ASBA in this stranded cost proceeding?**

4
5 A. Expert testimony in regulatory proceedings is but one of a number of unregulated
6 value added energy-related services Energy Services provides to customers. Energy
7 Services recently acquired the consulting firm of Barakat & Chamberlin and, as a
8 result, possesses significant regulatory consulting resources.

9
10 **Q. Please summarize your testimony.**

11
12 A. The purpose of my testimony is two-fold. First, to present for the Commission's
13 consideration a proposal under which Arizona's public schools would receive a
14 variance or exemption from stranded cost recovery responsibility. This proposal is
15 based on public interest considerations. Second, in response to the procedural
16 orders previously issued in this proceeding, I will offer comment upon certain
17 aspects of Issues 6 and 1 identified in those orders.

18
19 **Q. Please describe ASBA's proposal for a variance or exemption.**

20
21 A. The Arizona schools have a strong and compelling public interest in paying little or
22 no stranded cost in connection with the transition to a competitive electric industry
23 in the state. Arizona school funding currently ranks 45th in the nation and is in a

1 state of crisis. This crisis extends to both funding of capital requirements and
2 keeping pace with inflation in maintenance and operation expenses. Any reduction
3 in electric bills would significantly lower the cost of educating K-12 students in
4 Arizona and, thus, make funds available for educational purposes and / or lessen the
5 education-related burden otherwise borne by Arizona taxpayers.

6
7 Through its appearance in this proceeding, ASBA is requesting that the
8 Commission expressly grant an exemption for Arizona public schools from any
9 stranded costs which may ultimately be determined by the Commission to exist as a
10 consequence of implementation of its electric competition rules. Such exemption
11 should also include exemption from any early stranded cost recovery that occurs
12 from the date an exemption is granted until the date when schools have choice of
13 supplier. ASBA believes the predicate to such a public interest exemption already
14 exists within the general context of the electric competition rules and the specific
15 language of R14-2-1615 (C) of the rules. That Section provides for Commission
16 consideration of “variations or exemptions from the terms or requirements of any of
17 the rules...[when] the public interest will be served by the variation or
18 exemption...”

19
20 ASBA believes that the creation of a variance or exemption for Arizona public
21 schools from any responsibility for payment of stranded costs would be consistent
22 with the public interests of the State of Arizona and its residents and taxpayers.

1 ASBA welcomes the opportunity to provide additional information to the
2 Commission if that would be helpful to its decision-making.

3
4 **II. ISSUE 6 (WHO SHOULD NOT PAY STRANDED COSTS)**

5
6 **Q. Should ASBA's members pay stranded costs?**

7
8 A. No.

9
10 **Q. Why not?**

11
12 A. As previously indicated, electric rate reduction resulting from an exemption from
13 stranded costs would significantly benefit the students who attend public schools
14 and / or Arizona taxpayers.

15
16 **Q. Please describe the fact situation for Arizona's public schools and discuss the
17 public interest arguments in their favor:**

18
19 A. The situation is:

- 20
21 1. Arizona schools funding ranks 45th lowest among the nation's 50 states. This
22 unfortunate state of affairs is due, in part, to the fact that funding for the
23 maintenance and operations of schools has failed to keep pace with inflation

1 for nine of the past ten years. The Legislature also is currently under a
2 judicial mandate to devise a more equitable system of funding capital facilities
3 and equipment. Clearly, obtaining additional revenues for public schools in
4 Arizona will be extremely difficult and, thus, achieving all possible cost
5 reductions is imperative.

- 6 2. Electric rate reductions could beneficially factor into an overall solution to
7 improvement of Arizona school funding.
- 8 3. Schools in low property wealth districts and schools with older facilities are
9 likely to be the least efficient consumers of electricity today and stand to
10 benefit the most from electricity price reduction by virtue of their
11 corresponding greater electricity consumption.
- 12 4. A number of parties have proposed that stranded cost recovery be in
13 proportion to current rate design. Yet, some schools may have little or no
14 operations during Arizona's hot summer months and some may not have air
15 conditioning, yet the design of their current utility tariffs does not fully
16 consider the benefits of such off-peak consumption.
- 17 5. Ultimately, if Arizona's schools pay any stranded costs, they generally will be
18 paid from money that could otherwise go into classrooms and / or passed on to
19 Arizona's residences and business through taxes higher than otherwise to fund
20 schools. In the latter instance, it makes no sense to impose the public schools'
21 allocation of stranded costs on residences and businesses that are **already**
22 being asked by the utilities to pay stranded costs on their **own** homes and
23 business facilities. It is simpler to exempt the schools.

1 6. At least one utility, APS, believes there will be significant loss of tax revenues
2 in Arizona as a result of electricity competition. The highly publicized and so
3 called "Pollock" study predicts a \$1 billion loss in state and local taxes. The
4 study also discusses the potential for shutdown of power plants in Arizona:

5
6 Based on what has happened in other industries that have been
7 deregulated, and based on what has happened to generation
8 capacity in the United Kingdom, it would not be unusual to
9 see uneconomic assets, in terms of generation capacity, being
10 closed down. Plants at risk are those with high variable, but
11 potentially avoidable costs, in such areas as fuel expenses,
12 payroll and property taxes that exceed current market prices,
13 such as coal plants facilities. The APS Cholla plant in Joseph
14 City, Arizona, Tucson Electric Power's Springerville plant and
15 Salt River Project's Coronado facility could someday fall into
16 this category. (Pollock testimony, page 18.)
17

18 For example, the plant (Cholla) represents 97% of the full cash
19 value in the Joseph City School District and 96% of the Joseph
20 City School District's funding comes from local property
21 taxes. (Pollock, page 20.)
22

23
24 APS's CEO Mr. William Post cited the study in a February 28, 1997, letter to
25 the Arizona Legislature and then Governor Symington.

26
27 Therefore, APS has endorsed a study that predicts devastating revenue loss or
28 significant tax shifts for some Arizona schools and has also requested that
29 those same schools pay stranded costs. If the envisioned impact of
30 deregulation on school finance is likely to occur, then clearly it is appropriate
31 to exempt schools from stranded cost recovery.

1 **Q. How should the utilities recover any shortfall resulting from exempting the**
2 **Arizona schools?**

3
4 A. This is a policy call for the Commission. The ASBA is of the opinion that any
5 shortfall should **not** be recovered from other utility customers, but left for the utility
6 to mitigate or absorb. The ASBA's opinion is based, in part, on the tremendous tax
7 relief utilities have received in recent years.

8
9 The shortfall created by a schools exemption is likely a small amount relative to
10 total utility revenues. I estimate the Arizona K-12 grades contribute no more than
11 1 to 2 percent of statewide electric utility revenues. The affected utilities could
12 easily confirm this statistic. Assuming stranded costs are 10% of total utility costs,
13 then stranded costs attributable to Arizona's schools are **no more than 0.1%** to
14 0.2% of statewide electric utility revenues. Thus, while being relieved of these
15 costs will be very important to schools, the reduced revenue will be of little
16 consequence to the utilities.

17
18
19 **III. ISSUE 1 (RULES CHANGES)**

20
21 **Q. Are changes to the Commission's electricity restructuring rules necessary in**
22 **order for the schools to prevail?**

23

1 A. No. In fact, the basis for ASBA's request has its origins in the electricity
2 restructuring rules themselves. Section R14-2-1615 (C) of the Commission's
3 December 26, 1996, electricity restructuring rules states:

4

5 The Commission may consider variations or exemptions from
6 the terms or requirements of any of the rules in this Article upon
7 the application of an affected party. The application must set
8 forth the reasons why **the public interest** (*emphasis added*) will
9 be served by the variation or exemption from the Commission
10 rules and regulations.
11

12

13 Hence, under the current rules the schools could file an application for an
14 exemption from Section R14-2-1607 (Recovery of Stranded Cost) and set
15 forth the reasons for why the public interest is served by a Commission
16 approved exemption from stranded costs. And, although it would
17 additionally make sense for the Arizona schools to be eligible for direct
18 access no later than January 1, 1999, in order to obtain competitively priced
19 electricity, this is not absolutely necessary for the schools to be granted an
20 exemption from stranded costs.

21

22 **Q. Are you suggesting that the Commission established a new avenue for**
23 **obtaining rate concessions from affected utilities in their December 26, 1996,**
24 **electricity restructuring rules?**

25

1 A. In essence, yes. For a number of years, the Commission has approved rate
2 reductions from tariffs or special contracts for customers that successfully
3 demonstrated a viable competitive alternative. For example, the threat of customer
4 self-generation has led to reduced electric prices.

5

6 As the ASBA and I read the Commission's electricity competition rules, it appears
7 the Commission has established a similar exemption for customers successfully
8 demonstrating the public interest will be served through a granting of an exemption.

9

10 **Q. Has any entity to-date applied for an exemption under Section R14-2-1615**
11 **(C)?**

12

13 A. Not that we are aware of. Thus, the schools could be a test case for this new
14 standard.

15

16 **Q. Do you believe the Arizona public schools should be granted an exemption**
17 **from paying stranded costs?**

18

19 A. Yes. I believe granting the Arizona public schools such an exemption is strongly in
20 the public interest. The ASBA requests the Commission grant, in their Order in this
21 proceeding, an exemption from paying stranded costs for the Arizona public
22 schools to further the public interest. The ASBA requests the exemption be made
23 effective upon the date of the Order so as to also exempt the public schools from

1 any early stranded cost recovery programs. APS's regulatory asset recovery
2 program is an example of such an early recovery program.

3
4 **Q. Does Energy Services support stranded cost recovery by the Affected Utilities?**

5
6 A. Yes. As Douglas A. Oglesby testified, Energy Services supports a reasonable
7 opportunity for Affected Utilities to recover stranded costs but only if they
8 voluntarily sell generation assets. However, we note that the Commission has
9 created exemptions from stranded costs for self-generation and demand-side
10 management. ASBA has asked Energy Services to assist it in demonstrating to the
11 Commission that the public interest also warrants an exemption from stranded costs
12 for Arizona's public schools, and we are pleased to be able to provide our expertise
13 on their behalf to obtain lower electricity costs.

14
15 **Q. Does this conclude your testimony?**

16
17 A. Yes.

18
19 98-04/ASBA Broderick testimony.doc/1-16-98

**Professional Background and Experience
of
Tom Broderick**

Mr. Broderick has 14 years of experience in regulatory and economic issues in the electric industry. Currently, he is a Regulatory Consultant for PG&E Energy Services. His responsibilities include electric de-regulatory advocacy and analysis in Arizona, New Mexico, Utah and Nevada. He has recently testified in the Arizona, New Mexico and Utah legislatures on electricity deregulation. He has been an active participant in the Arizona Commission's recent work groups on electricity restructuring.

Prior to consulting for PG&E Energy Services, he was employed by Arizona Public Service Company from 1984-1996. At APS, Mr. Broderick served as Regulatory Economist, then Regulatory Affairs Supervisor, then Forecasts Department Supervisor and Chief Economist, then Planning Manager. In these various capacities, he prepared testimony for APS personnel or for himself in numerous rate cases, prudence audits, and integrated resource plan hearings. Mr. Broderick was responsible for preparation of APS's load forecasts for many years. Beginning in 1994, Mr. Broderick was responsible for analysis and strategy recommendation in preparation for electric deregulation.

Prior to joining APS, Mr. Broderick was a Marketing Research Analyst for Miller Brewing Company, Milwaukee, Wisconsin. Before that, he was an Economist for an Illinois state agency that regulated hospitals.

Mr. Broderick holds a Master of Science from the University of Wisconsin - Madison and a Bachelor of Science from Arizona State University.

BEFORE THE ARIZONA CORPORATION COMMISSION

REBUTTAL TESTIMONY OF

JOHN H. LANDON

ON BEHALF OF
ARIZONA PUBLIC SERVICE COMPANY
DOCKET NO. RE-00000C-94-0165

FEBRUARY 4, 1998

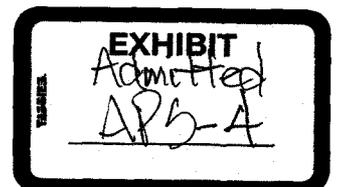


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1 I. QUALIFICATIONS

2
3 Q. Please state your name and business address.

4 A. My name is John H. Landon, and my business address is Two Embarcadero
5 Center, Suite 1160, San Francisco, California, 94111.

6 Q. What is your current position?

7 A. I am a principal and director of the utility practice of Analysis Group Economics,
8 an economic consulting firm.

9 Q. Please outline your educational background.

10 A. I received a B.A. degree with highest honors from Michigan State University with
11 a major in economics in 1964. I subsequently attended graduate school at Cornell
12 University, where I was awarded an M.A. in economics in 1967 and a Ph.D. in the
13 same field in 1969.

14 Q. Where were you employed after leaving Cornell university?

15 A. I served on the faculty of Case Western Reserve University from 1968 to 1973,
16 rising from the rank of assistant professor to associate professor, and on the
17 faculty of the University of Delaware from 1973 to June 1977 as an associate
18 professor.

19 Q. What subjects did you teach during this period?

20 A. I taught microeconomics, industrial organization, antitrust economics, regulatory
21 economics and economic forecasting.

22 Q. Where were you employed after leaving the University of Delaware?

23 A. I was employed by National Economic Research Associates from 1977 to 1997 as
24 a Senior Consultant, a Vice President and Senior Vice President and member of
25 the Board of Directors.

26 Q. What was the nature of your assignments at NERA?

27 A. Much of my work at NERA was on issues relating to the application of economic
28 principles to the electric utility industry. I participated in numerous projects
29 addressing economic and related antitrust issues before the Federal Energy
30 Regulatory Commission (FERC), the Nuclear Regulatory Commission (NRC), the

1 Securities and Exchange Commission (SEC), state regulatory commissions, and
2 federal and state district courts.

3 **Q. When did you join Analysis Group?**

4 A. I joined Analysis Group in March of 1997.

5 **Q. Have you previously testified?**

6 A. Yes. I have testified on many occasions before state and federal courts and
7 regulatory agencies on a variety of matters.

8 **Q. Have you testified before the Arizona Corporation Commission before?**

9 A. Yes. I have submitted testimony before this Commission on a variety of rate and
10 regulatory matters, including incentive pricing and electric restructuring issues.

11 **Q. Have you participated in retail access or electric restructuring in
12 jurisdictions other than Arizona?**

13 A. Yes. I have been involved extensively with retail access or restructuring issues in
14 Texas, New York, Michigan, Nevada, Ohio, Iowa, Florida, Louisiana, Oregon and
15 in the Province of Alberta. Outside North America, I have participated in teams
16 working on these issues in the U.K., Chile and Colombia. I have testified in
17 Arizona, Michigan, Texas, Pennsylvania, Iowa and Florida on these issues. A copy
18 of my resume is attached as Exhibit I to this testimony.

19 **Q. Have you testified on the subject of stranded investment?**

20 A. Yes. I have testified on stranded investment issues in Michigan, Iowa, Texas,
21 Arizona and before the Federal Energy Regulatory Commission. I have also
22 assisted utilities in negotiating with large customers on issues relating to stranded
23 investment recovery.

24
25 **II. PURPOSE OF TESTIMONY**

26 **Q. What is the nature of your assignment in connection with this proceeding?**

27 A. At the request of Arizona Public Service ("APS" or "the Company"), I have
28 reviewed the testimonies filed by parties in this proceeding. I will address issues
29 that have been raised relating to: 1) the importance of stranded investment

1 recovery; 2) mitigation of stranded investment; 3) the means of calculating
2 stranded investment; and 4) the means of recovering stranded investment.
3

4 **III. EXECUTIVE SUMMARY AND ORGANIZATION OF TESTIMONY**

5 **Q. Why are stranded cost issues important?**

6 A. Utilities have invested substantially in generation, transmission and distribution
7 capacity to satisfy existing and future electric power requirements of Arizona
8 consumers. The ongoing restructuring that is occurring in the electricity industry
9 is expected to enable all customers to enjoy the benefits of a more competitive
10 market, including lower rates and the introduction of more innovative products
11 and services. A key restructuring issue concerns how to deal with so-called
12 uncompetitive or potentially stranded costs. Stranded costs are prudently incurred
13 costs that a utility will be unable to recover from competitive market prices in the
14 transition from traditional cost-of-service ratemaking to a deregulated, market-
15 driven environment. These costs include costs currently on the books, as well as
16 any of the costs of the systems required to introduce open access which will not be
17 recovered in market prices. Estimated in the billions of dollars nationally, stranded
18 costs are probably the most daunting regulatory issue facing electric utilities today,
19 as well as the most significant impediment to restructuring. There are, however,
20 numerous other impediments. I discussed many of them in my testimony of
21 November 27, 1996, in the Commission's rulemaking Docket No. R-0000-94-165.
22 They include maintaining system reliability, real-time pricing for settlements among
23 suppliers, developing metering, billing and load profiling systems, developing
24 settlement and reconciliation processes, developing a means to supply and market
25 ancillary services, and developing rules for entry of suppliers and reciprocity
26 between states.

27 **Q. How is your testimony organized?**

28 A. The paper is organized as follows. Section IV discusses the definition and causes
29 of stranded costs. Section V discusses why full recovery of stranded costs is in the
30 best interests of both customers and shareholders. Section VI outlines mitigation

1 issues involved with stranded cost recovery. Section VII discusses alternative
2 mechanisms for calculating stranded costs. Section VIII discusses alternative
3 methods to recover stranded costs. Section IX explains why rate freezes and price
4 caps are inconsistent with competitive markets. Section X resummaries my
5 conclusions.

6 **Q. Would you please summarize your conclusions?**

7 **A.** Yes. I have concluded that:

- 8 1. Stranded costs arise out of a breach in the regulatory compact that has
9 historically governed the relationship between regulators and utilities;
 - 10 2. Providing full recovery of stranded costs is consistent with:
 - 11 a. The regulatory compact,
 - 12 b. The economic concept of governmental takings,
 - 13 c. Efficiency,
 - 14 d. Good price signals,
 - 15 e. Competitive markets,
 - 16 f. Lack of timely warning,
 - 17 g. Lack of past compensation for risk,
 - 18 h. Not imposing consumer costs on stockholders;
 - 19 3. Reasonable mitigation of potentially stranded costs should be expected, but
20 only through the regulated activities of the utility. Past cost cutting should also
21 be factored into what can be reasonably expected in the future;
 - 22 4. The net revenue lost calculation method has substantial advantages over a
23 forced auction in the valuation of stranded investments. Properly implemented,
24 a net revenue approach can avoid the need for a true-up mechanism. Valuation
25 of stranded costs by issuing a special class of stock would not be sound and
26 has severe economic and practical defects;
 - 27 5. Rate freezes and caps are generally inconsistent with a competitive market and
28 should be discouraged.
- 29

1 auxiliary services to an open access environment. Examples include installing
2 new metering or billing systems, developing an independent system operator,
3 and installing new computer systems required to accommodate changes in bulk
4 power settlements, metering and bill processing. The costs associated with
5 developing the computer systems required for open access can be substantial.
6 For example, the cost of the computer systems for the California independent
7 system operator and the power exchange is estimated to be over \$200 million.
8 There may also be costs associated with obligations the incumbent utility is
9 asked to take on in the transition to competition.

10 **Q. Are there ongoing costs that should be included with stranded costs?**

11 **A.** Yes. Any prudent investment made or cost incurred during the regulatory regime
12 must be considered when evaluating stranded costs. Regardless of when the
13 decision to make the transition is made or when the transition to competition is
14 initiated, all prudently incurred costs of the regulated utility should be collectable.
15 For example, incumbent utilities may continue to bear the obligation to serve some
16 or all consumers for some period after the introduction of retail access. This may
17 cause additional stranded costs if prices in effect during the transition period are
18 insufficient to recover these costs. Incumbents may also be obliged to provide
19 system reliability services. Their provision may or may not be fully compensated
20 by rates in effect. Furthermore, many incumbent utilities face unavoidable (and
21 potentially unrecoverable) costs on an ongoing basis to meet their obligations
22 under existing regulation. Although the burden of demonstrating what costs
23 should be eligible for recovery lies with the utility, regulators must be careful to
24 ensure that the process of identifying and recovering stranded costs includes not
25 only those costs incurred prior to the decision to introduce competition, but also
26 those prudent costs incurred as a result of existing regulatory obligations or as part
27 of the transition to competition.

28 **Q. How does your definition of stranded cost relate to the ACC's definition?**

29 **A.** My definition is similar to the ACC's definition, except that the ACC's definition
30 appears to limit recovery to expenditures that were made "prior to the adoption of

1 this Article." For the reasons stated above, I do not believe it is appropriate to
2 ignore expenditures that were made after December 31, 1996.

3
4 **V. FULL STRANDED COST RECOVERY IS APPROPRIATE**

5 **Q. Several witnesses have argued against full stranded cost recovery. Why**
6 **should utilities be allowed to recover their stranded costs?**

7 A. A number of legal and economic arguments justify compensating a utility for its
8 stranded costs, including 1) the promotion of economic efficiency; 2) the
9 regulatory compact and the unique nature of regulated industries; 3) fairness and
10 capital cost concerns about the lack of advance warning or investor compensation;
11 and 4) the hastening of retail competition.

12 **1. Economic Efficiency Issues**

13 **Q. Do you agree with the assertions, made by witnesses Cooper, Coyle, Rose,**
14 **and Rosenberg, that there are no efficiency reasons supporting the recovery**
15 **of stranded investments?**

16 A. No. Uncompensated stranded costs will create an opportunity for "uneconomic
17 bypass" by inefficient entrants. Utility costs that are not offset by revenue are
18 often called incumbent burdens, or uncompensated transition costs. Entrants, who
19 do not face these costs, would be able to compete successfully with incumbents
20 even if they did not have lower production costs. As a result, inefficient firms may
21 end up providing services. Incumbent burdens can relate to costs incurred in the
22 past which have not been recovered or to additional costs the incumbent may
23 undertake related to the transition to competition. Developing a method to ensure
24 recovery of past prudent costs, whether through a nonbypassable charge to all
25 customers or charging entrants a fee so that transition costs are shared equitably
26 among competing utilities, will allow for a level playing field so that all firms may
27 compete on the basis of production costs.

1 Q. **Can you provide an example illustrating how uncompensated stranded costs**
2 **can create an opportunity for uneconomic bypass by inefficient entrants?**

3 A. Certainly. Assume that the marginal cost of generation is 2 cents per kWh for the
4 incumbent and 4 cents per kWh for entrants. Assume further that there are
5 incumbent burdens of 4 cents per kWh. Hence, the entrant will be able to undercut
6 the incumbent's total cost by 2 cents per kWh, even though the incumbent has a
7 lower marginal generation cost than the entrant. This, of course, is inefficient
8 because more scarce resources are consumed if the entrant generates the electricity
9 instead of the incumbent. This problem can be dealt with by charging incumbent
10 burdens to all customers or assessing them equally across all suppliers.

11 Q. **Why is it important for generation companies to compete on the basis of**
12 **relative production costs?**

13 A. A fundamental tenet of economics is that the price of a good should reflect the
14 relative value of the inputs used to produce it. Information on the value of inputs
15 is transmitted through the market price, which is determined by the marginal cost
16 of the last unit produced. However, if fixed costs are allowed to enter
17 asymmetrically into the price determination mechanism, this will create a wedge
18 between the good's true cost to society and its market price. In the case of
19 electricity, if incumbent utilities are saddled with stranded costs, this will create a
20 wedge that may allow generation companies with higher marginal costs of
21 production than the incumbent to enter the market. The entry of high-cost
22 generation would result in a welfare loss to society.

23 Q. **Are there any other inefficiencies created by disallowance of stranded cost**
24 **recovery?**

25 A. Yes. Failure to allow the opportunity for stranded cost recovery will also create
26 capital cost related inefficiencies. Saddling incumbent firms with stranded costs
27 creates financial weakness and increases the return that will be required by future
28 investors, making it more costly for incumbents to maintain and modernize their
29 facilities. High capital costs caused by regulatory uncertainty will also tend to raise
30 costs for those services that remain regulated.

1 Q. **Witness Rose dismisses the importance of uneconomic bypass. Do you agree**
2 **with his analysis?**

3 A. No. Uneconomic bypass can be a significant problem. Dr. Rose correctly notes
4 that uneconomic bypass will occur when "the alternative supply option has a
5 marginal cost less than the utility's rate but greater than the utility's marginal
6 cost." (p. 11) However, he assumes that this will only occur in "very limited
7 circumstances." It is unclear how Dr. Rose arrives at this conclusion. Incumbents
8 will frequently have lower marginal cost than potential entrants. In addition, the
9 greater the stranded cost burden of incumbent utilities, the larger the potential
10 wedge between price and marginal cost and, therefore, the greater the opportunity
11 for uneconomic bypass by inefficient producers.

12 In addition to questioning the likelihood of uneconomic bypass, Dr. Rose
13 dismisses its importance for two other reasons. First, Dr. Rose argues that
14 unbundling of rates will avoid this problem. However, he overlooks the fact that
15 the Commission will establish a provider of last resort and set bundled generation
16 rates that include a contribution to fixed costs. If competitive service providers or
17 their customers do not bear any responsibility for recovering stranded costs, it is
18 not hard to imagine a situation in which a firm with marginal costs above those of
19 the incumbent, but below the bundled default rate, would be able to enter the
20 market successfully. This would harm both consumers and other producers.

21 Second, Dr. Rose asserts that uneconomic bypass, "even if it does occur,
22 [would have] a minor effect on overall efficiency when compared to the gain in
23 dynamic efficiency induced by a competitive market." (p. 12) Dr. Rose fails to
24 substantiate his conclusion. But, more importantly, he completely misses the fact
25 that proper price signals and properly designed stranded cost recovery are required
26 for dynamic efficiency. Correctly designed stranded cost recovery will ensure that
27 producers compete on the basis of relative marginal costs, causing the dynamic
28 competitive market in Arizona to flourish, to the benefit of all consumers.
29 Ignoring stranded cost or improperly designing the recovery mechanism will impair
30 competition and limit its benefits.

1 Q. **Will allowing recovery of stranded cost hasten the transition to competition?**

2 A. Yes. Allowing recovery of stranded costs hastens the transition from a fully
3 regulated regime to a more competitive environment by lowering legal barriers and
4 allowing incumbent firms to cooperate actively in facilitating a rapid transition to
5 competition. Absent resolution of the issue, fiduciary duties to protect financial
6 rights of stockholders, and concerns that incumbent disadvantages may greatly
7 handicap their ability to succeed, will limit the ability of utilities to cooperate with
8 a rapid movement toward competition. Stranded cost recovery "settles up" the
9 remaining costs associated with the regulatory period and allows all parties to
10 focus on competition.

11 Q. **Could the nature of the transition to competition affect the magnitude of
12 stranded costs?**

13 A. Yes. If the transition is not properly done, there is a real likelihood of further
14 stranded costs. Under regulation, an incumbent firm has an obligation to supply all
15 customers and to supply other mandated programs (e.g., low-income and energy
16 efficiency programs). If the transition to competition leaves the costs of providing
17 expensive money-losing programs and services with the utility but takes the most
18 profitable businesses, the utility will be hurt. Entrants that can choose their
19 customer base and service offerings will naturally choose only profitable areas of
20 entry. Continuing service obligations for incumbents, if improperly done, can
21 result in an adverse selection process whereby profitable customers and services
22 are drawn away by competitors, leaving the incumbent with a high-cost customer
23 base and providing uneconomical services. One solution to the adverse selection
24 problem is to require that all suppliers contribute to any remaining social programs.
25 By spreading the burden of social programs across all market participants,
26 regulators will ensure that firms enter the market only if they are more efficient
27 than the incumbent utility.

1 Q. **Staff witness Rose argues that the utility should not be allowed to recover its**
2 **stranded costs because this will impede the development of a competitive**
3 **market. Do you agree?**

4 A. No. It is fairly straightforward to design rates that will both recover stranded costs
5 and avoid distorting the price signal. In his example on page 11, Dr. Rose fails to
6 apply a fundamental principle of economics – that to be nondistortionary, any cost
7 recovery charge (*e.g.*, a CTC) must be applied uniformly to all participants. If Dr.
8 Rose had applied the transition charge to all producers in his example, the
9 hypothetical customer would have chosen the supply option with the lowest
10 marginal cost.

11 Q. **Dr. Rose argues that allowing stranded cost recovery will create barriers to**
12 **entry and exit. Do you agree?**

13 A. No. Dr. Rose's definition of barriers to entry seems to suggest that any cost
14 associated with entering a market should be considered as a barrier to entry. This
15 definition, however, is not useful. There are always costs and delays associated
16 with entering a market. To distinguish as a barrier to entry anything that prevents
17 a firm from instantaneously entering a new market at no cost is so overly
18 restrictive that it has little substantive meaning.

19 A barrier to entry that merits concern is one that artificially creates a
20 substantial cost asymmetry between incumbent and entrant. This is quite different
21 from a concern with all costs associated with entry, as Dr. Rose suggests.

22 An example of a barrier to entry is a legal limit on the number of taxicabs
23 or taxicab providers in a city. Such restrictions can make it impossible for new
24 firms to enter the market, to the benefit of incumbent firms and the detriment of
25 consumers. However, in the retail electricity market, there will be no limit on the
26 number of participants, nor will there be any other substantial barrier to entry.

27 Since a properly designed stranded cost recovery mechanism will be
28 applied symmetrically to all customers or all sellers, not just new entrants or their
29 customers, new entrants would not bear any asymmetric costs to enter the market
30 which might advantage established firms. Furthermore, an efficient collection

1 mechanism will only recover transition costs or unavoidable costs that are stranded
2 as a result of retail access or the transition. Sunk costs and their recovery do not
3 affect the marginal cost or revenues associated with gaining or losing customers.
4 Thus, stranded cost recovery will have no significant impact on the ability of firms
5 to compete over time. Market prices will be determined by the costs required to
6 meet the last unit of demand in each hour of each day.

7 **Q. Witness Rose also argues that stranded cost recovery will create barriers to**
8 **exit. Do you agree?**

9 A. No. Dr. Rose is mistaken in his contention that stranded cost recovery would
10 encourage inefficient producers to continue supplying the market. Under a
11 properly designed recovery mechanism, incumbents will have the opportunity, but
12 not the assurance, of recovering the investments left on their books from the prior
13 regulated regime and all energy service providers will compete on the basis of
14 marginal costs. Inefficient producers will be forced to either improve operations
15 or shut down and exit the market. Consequently, stranded cost recovery will not
16 create barriers to exit in the electric generation business. Moreover, incumbent
17 utilities and other producers will make investments required to remain in the
18 electric business in their service areas only if they expect that profits from doing so
19 will be comparable with other investment opportunities.

20 **Q. Several witnesses (Rose, p. 9; Rosenberg, p. 7-8) argue that stranded cost**
21 **recovery will afford incumbents an unfair competitive advantage. Do you**
22 **agree?**

23 A. No. Dr. Rosenberg's assertion that stranded cost recovery "allows a supplier with
24 above market costs to compete unfairly with potential or actual competitors
25 because some of its costs are subsidized by strandable cost recovery" is unfounded
26 and incorrect. In fact, correctly designed and implemented stranded cost
27 compensation will ensure that competition based on production costs can take
28 place effectively. Dr. Rosenberg's conclusion is based on the "sunk cost fallacy."
29 It is a fundamental truth of competitive markets that firms will make production
30 decisions based on avoidable or marginal costs, not sunk or unavoidable costs.

1 To see this more clearly, assume sunk cost or unavoidable costs for the
2 incumbent utility are \$500 million, and marginal or avoidable generation costs are
3 2 cents per kWh for the utility, and 4 cents per kWh for the entrants, respectively.
4 Marginal costs will correctly signal customers in the market that the incumbent has
5 the lowest marginal cost. The sunk cost of \$500 million should have no bearing on
6 either the choice of supplier or the amount that a supplier should generate. The
7 purpose of stranded cost recovery is to allow firms to recover those previously
8 incurred (sunk) investments that are unrecoverable due to the onset of
9 competition. Stranded cost recovery does not subsidize operating costs or
10 incremental capital costs.

11 By recovering stranded costs through a competitively neutral mechanism,
12 such as non-bypassable wires charge, no firm will have a competitive advantage. A
13 competitively neutral charge will help ensure that stranded costs are recovered and
14 that lowest-cost firms provide the generation service.

15 **Q. Will stranded cost recovery charges result in incumbent over-recovery of**
16 **stranded costs and create a competitive disadvantage for entrants?**

17 A. No. A properly designed mechanism will leave the incumbent with assets valued at
18 market prices. Moreover, since all incumbents and entrants will pay the same CTC
19 charge, new entrants are not disadvantaged. Furthermore, recovery of stranded
20 costs will not affect marginal costs or marginal revenues and thus will not affect
21 the incumbent utility's competitive position.

22 **Q. Is the value of incumbency anti-competitive, as Dr. Rose claims (p. 9),**
23 **blocking equally qualified or superior entrants and preventing competition**
24 **from occurring?**

25 A. No. Quite the opposite is true. It is a defining feature of competitive markets that
26 the top incumbent's position is perpetually challenged by rivals and new entrants.
27 Those firms with differential advantages are able to overcome the advantages of
28 incumbents and provide benefits to consumers by offering new products and
29 services, at lower prices. If entrants prove superior to incumbents in some way,
30 they will gain customers at the expense of the incumbents. If the competitive

1 advantages of superior firms are eliminated, the competitive process is subverted,
2 allowing inferior firms to survive and eliminating benefits to consumers. This
3 would misallocate resources and harm consumers. Regulators should be
4 concerned about abuse of market power and anti-competitive behavior. However,
5 a properly designed stranded cost recovery will be symmetric for all market
6 participants and, consequently, will have no bearing on the potential for anti-
7 competitive behavior. Therefore, concern about market power abuses does not
8 justify the denial of full stranded cost recovery.

9 **Q. In a competitive market, are not all firms relatively equal in terms of name**
10 **recognition, marketing costs, reputation, and goodwill?**

11 A. No. In competitive markets, firms generally differ widely in their abilities,
12 reputations, and performance. Competition brings out this diversity. Firms
13 differentiate their products and service in order to attract sales from their rivals.
14 Competition drives firms to improve their products and service and to lower costs
15 and prices to gain and retain customers. New entrants are forced to overcome
16 existing firms' reputation advantages and customer loyalty by offering competitive
17 or superior products, service, and prices. Unless new entrants can succeed on
18 their merits, they do not belong in the business. Penalizing incumbents for their
19 superiority over rival firms serves only to harm consumers.

20 **Q. Does name identification via incumbency necessarily bestow a competitive**
21 **advantage on incumbent electric utilities?**

22 A. It is possible but by no means automatic. A utility may be well known in terms of
23 name recognition but have a poor reputation for service and pricing. Some utilities
24 have invested heavily in providing high quality customer service while others have
25 allowed service to deteriorate. The reputation of a utility and thus the loyalty of
26 consumers in remaining with the incumbent varies across utilities depending on
27 their historic record of service and value to customers. Customers who believe
28 they have received poor service, excessive prices, or both are highly motivated to
29 consider alternative suppliers. Name identification in that case is a negative,
30 associated with consumer ill will. There is nothing about incumbency per se that

1 guarantees strong consumer loyalty in the face of new competition. Indeed, name
2 recognition may be a handicap, aiding new entrants in their quest for customers. It
3 is not surprising that some utilities choose to market competitive services under a
4 separate name.

5 **Q. But what of Dr. Rose's assertion that consumers will not investigate**
6 **alternatives?**

7 A. Dr. Rose provides no evidence to support this view. He writes as though it is
8 obvious that consumers are either too lazy to make a choice or too stupid to
9 choose in their own best interest. Consumer behavior in actual markets
10 overwhelmingly refutes this view. Consumers make choices in their own best
11 interest. At times this means remaining with their current supplier, since the
12 benefits of switching do not outweigh the costs. This is just as much of a "choice"
13 as a decision to switch suppliers. Consumers dissatisfied with current service will
14 consider the alternatives and switch if, in their judgment, the benefits justify the
15 cost of switching. In an analogous situation, millions of long-distance customers
16 have switched from AT&T over the years to its rivals, as well as between non-
17 AT&T rivals, when given the opportunity to save on various products and to
18 obtain better service. Others have elected not to switch or have switched and
19 come back. There is no reason to believe that electric power consumers will
20 behave any differently. Consumers act in their own best interest, so if rivals can
21 provide superior service and prices to those offered by APS, consumers will
22 readily switch to them. Additionally there is, at the outset, a much lower level of
23 national concentration among electric suppliers than there was in the telephone
24 business.

25 Failing to choose a rival over APS does not mean that consumers suffer
26 from inertia or have merely relied on APS's name identification and good will
27 Consumers are not stupid, especially when it comes to shopping for products and
28 services. They select goods and suppliers according to what best serves their
29 interest as reflected in the benefits and costs of the alternatives available. If APS
30 has invested in providing good service, creating a positive reputation and strong

1 would outweigh any short-run or static losses due to pricing above marginal cost.
2 He makes this point by misinterpreting the analysis of respected economist Alfred
3 Kahn. In the passage Dr. Rose cites, Kahn was discussing AT&T's ability to, at its
4 long-run marginal cost, price below most of its rivals. Thus, the context in which
5 Kahn was making this argument is a market where the incumbent is assumed to be
6 the lowest-cost producer, and all potential entrants have higher marginal costs.
7 This is a scenario that does **not** describe the generation market in Arizona. It is
8 extraordinary to suggest that other firms cannot compete with incumbent utilities
9 and that uneconomic bypass is the only way entry will occur in a newly
10 competitive retail market in Arizona. Requiring incumbents to price above their
11 marginal costs would be antithetical to economic efficiency in both the short and
12 long run. Indeed, in a January 30, 1998, letter to the Wall Street Journal, Alfred
13 Kahn argues eloquently that regulators must distinguish between promoting
14 competition by ensuring efficient producers the opportunity to enter markets, and
15 protecting competitors from genuine efficiency advantages of their rivals, which
16 would significantly harm consumer welfare.

17 Stranded cost recovery, far from being an obstacle to dynamic efficiency, is
18 important to the long-run viability of competition in Arizona. All parties to the
19 process expect entry to occur once a competitive market is established.

20 **2. *Comparison with Competitive Firms***

21 **Q. How does your view of the origin of stranded costs differ from Dr.**
22 **Rosenberg's?**

23 **A.** Dr. Rosenberg attributes stranded costs to "managerial decisions and engineering
24 innovations." (p. 6) As I indicated earlier in my testimony, stranded costs arise
25 from the introduction of competition in an industry in which past decisions were
26 based on a regulatory compact.

27 **Q. Does Dr. Rosenberg's view of stranded costs' origins agree with the**
28 **Commission's?**

29 **A.** No. In R14-2-1601, the Commission defines stranded costs as the following:

30 "Stranded Cost" means the verifiable net difference between:

- 1 a. The value of all prudent jurisdictional assets and obligations necessary
2 to furnish electricity (such as generating plants, purchased power
3 compacts, fuel compacts, and regulatory assets), acquired or entered
4 into prior to the adoption of this Article, under traditional regulation
5 of Affected Utilities; and
6 b. The market value of those assets and obligations *directly attributable*
7 *to the introduction of competition under this Article.* (emphasis
8 added)

9 **Q. Dr. Rosenberg argues that electric utilities should be denied stranded cost**
10 **recovery because firms in competitive markets typically cannot recover**
11 **uneconomic investments. Do you agree with this view?**

12 **A.** No. A regulated firm operates and invests under a different set of rules and
13 constraints than does a competitive firm. Unlike a company in the free market, a
14 regulated firm faces regulatory obligations as well as limits on both potential risk
15 and potential return on its investments. Therefore, the comparison Dr. Rosenberg
16 makes is not valid.

17 Utilities, such as APS, have been required to meet an obligation to supply
18 power and energy to all customers who locate in their service areas. This
19 obligation required long-lived investments made well in advance of actual growth
20 in demand. The quid pro quo was the limitation of competitive entry that would
21 allow the recovery of prudently incurred investments over their life. Some
22 investments may result in stranded costs because the regulatory compact under
23 which they were made will be breached. Specifically, entry by other firms means
24 that, in some cases, the utility may no longer be able to earn its agreed-upon rate
25 of return. Without this change in regime, the utility would continue to have the
26 opportunity to recover its investments along with a reasonable return, and there
27 would be no stranded costs. Losses from the investments occur because the
28 incumbent bears prudently incurred continuing costs that will not be compensated
29 through competitive markets.

1 Equating stranded costs with investment losses of competitive firms
2 ignores the regulatory obligations of an incumbent utility which required large
3 long-term investments to meet service obligations. These past investments have
4 generally been reviewed for prudence and placed in rate base. These costs were
5 based on a regulatory compact that is now being altered.

6 While the shareholders of competitive firms face no obligations to serve
7 and can earn unlimited returns on their investments, regulated firms face public
8 service obligations and limited returns.

9 **3. Advance Warning of Competition**

10 **Q. Some witnesses argue that incumbent utilities have had advance warning**
11 **about increased competition and should have been able to minimize stranded**
12 **costs. Do you agree?**

13 **A.** No. Recognition of increased competition has been of recent origin. In fact, early
14 regulatory pronouncements suggested that retail open access would not occur.
15 PURPA certainly did nothing to promote retail competition. The Energy Policy
16 Act of 1992 allowed only wholesale wheeling. To my knowledge, the issue of
17 retail open access was not significantly addressed in Arizona until 1996.

18 **Q. Do incumbent obligations limit the extent to which utilities can reduce**
19 **stranded costs or prepare for competition?**

20 **A.** Yes. In a competitive market, firms face constant pressure to operate efficiently
21 and only engage in those activities in which they are low-cost producers (and
22 consequently can sell at a profit). However, the existing regulatory paradigm
23 imposes significant cost burdens on incumbent utilities. These include providing
24 service to all customers in a given service territory, offering low-income programs,
25 planning and investing to meet future demand, and providing a host of other non-
26 market services. Many such obligations are unprofitable and would not be
27 provided on the same basis in a competitive market. Incumbents are limited in the
28 extent to which they can respond to anticipated changes in the marketplace, as
29 long as they continue to be obliged to provide these non-market services.

1 4. *Historical Compensation for Risk*

2 **Q. Several parties have argued that APS should not be allowed to recover its**
3 **stranded costs because it has already been compensated in rates for the risk**
4 **of stranded costs. Do you agree with this position?**

5 **A. No.** APS shareholders have not been compensated for the risk of stranded
6 investments. For shareholders to have been compensated for the risks associated
7 with stranded costs it must be assumed that the Commission, through a general
8 rate case or some other mechanism, increased rates sufficiently to enable existing
9 investors to recoup their original investment and to receive a return on invested
10 capital that is commensurate with the risk taken.

11 **Q. Do you believe that investors have received this compensation?**

12 **A. No.** Investors have not received the required compensation for several reasons.
13 First, the techniques used by the Commission to determine the utility's authorized
14 equity return would have measured the return required by the marginal (new)
15 investor, not the return required to compensate existing investors for stranded
16 costs. These techniques measure required equity returns based on such market
17 data as dividends, dividend growth, and stock price. Consequently, while these
18 techniques are capable of measuring the return that would be required to
19 compensate all investors (both existing and new) for the added business risk
20 associated with open access, they are incapable of measuring the additional return
21 that would be required to compensate existing shareholders for stranded costs.
22 The return that would have been required to compensate investors for the realistic
23 threat of having to write off billions of dollars of previously approved rate base
24 would have been large enough to be very evident. To the best of my knowledge,
25 there has been no such return either authorized or earned by APS.

26 For existing shareholders to have been compensated for the breach of
27 regulatory compact, the Commission would have had to have authorized a special
28 "risk premium" to compensate investors for stranded cost recovery. However, no
29 witness has cited any decisions or provided any evidence substantiating the claim
30 that the Commission has ever made such an adjustment. Moreover, if the

1 Commission did make such an adjustment, APS's authorized return would have
2 shown a significant increase. It is clear that this has not occurred. Consequently,
3 the evidence does not support the assertion that shareholders have been
4 compensated for risk of significant stranded costs.

5 As I have indicated, the increase in return required to compensate investors
6 for stranded costs exceeds what is consistent with actual experience. I illustrate
7 this point with the following hypothetical example. Assume for simplicity that the
8 Commission's estimate of stranded costs, as of the beginning of 1998, is \$500
9 million, and that the utility's earnings are a constant \$150 million per year on an
10 equity capital base of \$1,250 million. Assume further that the utility's authorized
11 equity return (before the adjustment to compensate shareholders for stranded cost
12 recovery) is 12 percent and that immediately following its investigation in 1996,
13 the Commission increased the utility's authorized return sufficiently to pay off the
14 estimated stranded costs by the beginning of 1998. Under these assumptions, the
15 *increase* in the equity return required to compensate shareholders for stranded
16 costs would be 19 percent ($500/(1250*(1+(1+.12)))$), assuming that investors can
17 reinvest funds at the utility's authorized equity return. This implies that the
18 authorized equity return during 1997 would have been 31 percent, which is clearly
19 contrary to actual experience.

20 **5. Regulatory Compact**

21 **Q. Witness Coyle claims that there has never been a recognized compact**
22 **between the utility and its regulatory commission that requires full recovery**
23 **of stranded costs. Do you agree?**

24 **A.** No. An understanding between utilities and regulators, as authorized by law, has
25 been a fact of regulatory law and economics for decades.¹ Under the agreement,
26 the utility cedes the right to independently price its services and accepts various
27 service obligations. In return, it receives protection from entry by competitors, and the
28 regulatory commission sets rates that will provide an opportunity for the utility to earn

¹ For an excellent discussion of the origins and history of the compact, see J. Gregory Sidak and Daniel F. Spulber in their new book Deregulatory Takings and the Regulatory Compact.

1 a return that is commensurate with the risk taken. Among the burdens unique to the
2 regulated utility industry, the incumbent is also required to: (1) comply with various
3 reporting requirements; (2) have its returns controlled by the commission; (3) provide
4 service to all customers within its service territory (often termed the utility's "obligation
5 to serve"); (4) meet quality and reliability standards; and (5) undertake social programs
6 that are deemed by the regulatory commission to be in the best interest of society.

7 In addition to service obligations and pricing restrictions, the regulatory
8 commission also approves many of the utility's investments and reviews the
9 utility's financial performance. The fact that private investors willingly invested
10 billions of dollars in the electric industry in the past is certainly strong evidence of
11 a regulatory compact. It is laughable to suggest that large, long-term investments
12 would have been made by firms, saddled as they were with service obligations and
13 market restrictions, without some assurance of earning a reasonable return on their
14 prudent investment. Even if they had wanted to make such investments, markets
15 would not have supported their capital requirements at anything like historic costs
16 of capital.

17 By allowing other firms to compete with the incumbent utility in the
18 generation market, the commission has signaled a fundamental change in the
19 regulatory compact. Entry by competitors increases risk to APS and is likely to
20 reduce the return that the utility can expect to earn. Eliminating the security of
21 arrangements which induced long-term investments represents a breach of the
22 regulatory compact between the utility and the commission. To avoid confiscatory
23 outcomes, the utility should be compensated for the reduced earnings resulting
24 from the change in the regulatory compact. The magnitude of the reduced
25 earnings is the value of the stranded costs that the utility should be able to recover
26 from its customers because of the breach.

27 Thus, while Mr. Coyle may be correct in asserting that there exists no
28 explicit contractual document between the utility and the regulatory commission,
29 allowing entry by competing firms is clearly contrary to past practice, on the basis

1 of which investments were made, and is likely to disadvantage the incumbent firm
2 greatly.

3 **Q. Can you explain some of the reasons why utilities have costs on their books in**
4 **excess of those the market will support?**

5 A. Yes. In the past, regulators have directed incumbent utilities to pursue many
6 public interest programs requiring substantial investments by the utilities. Perhaps
7 the most obvious of these mandated investments is the requirement that incumbent
8 utilities serve all consumers in their service territories at regulated rates, regardless
9 of the additional cost to serve them. Utilities have also been required to maintain
10 high levels of service quality and were obligated to build facilities in advance to
11 serve potential loads even if those loads might not materialize. While APS does
12 not have high reserve margins, many incumbent utilities do find themselves with
13 high reserve margins that are not economic in an open access environment.
14 Moreover, whether or not individual utilities have excess capacity, they will be
15 adversely affected by those that do.

16 A major cause of costs on the books in excess of those the market will
17 support is regulatory assets. Regulatory assets reflect costs that have been paid by
18 the utility and benefits that have been received by customers that, because of
19 commission policies, have not been fully collected in rates. The regulators have
20 required that collection be delayed. If the market will not support their recovery,
21 they become part of stranded costs that need to be recovered during the transition
22 to competition.

23 **6. *Sharing Stranded Costs Between Ratepayers and Shareholders***

24 **Q. Several witnesses (Higgins, Rosenberg, Malko, Coyle, Rosen, Rose, and**
25 **Cooper) argue that shareholders and ratepayers should share the stranded**
26 **cost burden to varying degrees. Is this a sound policy proposal?**

27 A. No. As I have stated previously, under the regulatory compact incumbent utilities
28 have the right to an opportunity to recover their prudent investments along with a
29 reasonable return on them. If regulators allow only a fraction of stranded costs to
30 be recovered, this will amount to a regulatory breach of compact. Anything less

1 than the opportunity for full stranded cost recovery is an economic taking of utility
2 shareholders' property.

3 **Q. What are economic takings?**

4 A. "Takings" is a legal and economic issue which relates to the government use,
5 regulation or confiscation of private property without providing adequate
6 compensation. I understand legally recognized, but uncompensated takings to be
7 prohibited by the Fifth and Fourteenth Amendments of the U.S. Constitution and
8 by the Arizona State Constitution. From an economist's perspective, takings are
9 compulsory property transfers (or their regulatory equivalent) without appropriate
10 compensation. If utility investors would be prevented from obtaining a reasonable
11 return on their invested capital as a result of open access, there would be a taking,
12 at least from the perspective of an economist. With open access, one of the things
13 "taken" is the earnings that investors expect to receive from the assets.
14 Shareholders provided funds with the expectation that they would receive, over the
15 life of the investment, a cash flow that would both repay their original investment
16 and provide a return commensurate with investments of similar risk. A change in
17 regulation that prevents investors from receiving this amount may be viewed as a
18 taking of private property without just compensation.

19 Also, open access itself can result in a form of physical taking, since the
20 utility is compelled to give up the unrestricted use and control of its facilities for
21 the wheeling of power provided by others and may be required to do so without
22 adequate compensation.

23
24 **VI. MITIGATION ISSUES**

25 **Q. Should utilities have the obligation to mitigate stranded costs in a reasonable
26 way?**

27 A. Yes. Stranded costs stem from the difference between assets acquired under a
28 regulatory regime and the value of those assets in a competitive market. However,
29 the utility may be able to take actions that reduce this difference in valuation. Such
30 actions are frequently referred to as mitigation efforts. Reducing, or mitigating,
31 total stranded costs lowers the total impact of the transition from regulation to

1 competition by lowering costs or increasing the value of the utility's assets in a
2 competitive marketplace. To increase the value of its assets, thereby lowering
3 stranded costs, the incumbent utility will try to operate more efficiently.

4 **Q. What is an appropriate standard for mitigation?**

5 A. The utility should be required to make reasonable efforts to mitigate stranded
6 generation investments by controlling generation costs and enhancing generation
7 revenues. The amount of mitigation expected should be realistic and consider the
8 extent to which the Company has already cut costs. Where possible, I strongly
9 favor providing financial incentives for the utility to be aggressive in mitigation by
10 allowing stockholders to share in the net benefits.

11 It would be inappropriate and counter-productive to hold the utility to a
12 standard of achieving perfection in mitigation. It would also be unfair to assess its
13 performance after the fact with the benefit of knowing market outcomes that utility
14 management could not have accurately predicted.

15 **Q. Witnesses Higgin and Rosen argue that profits from unregulated businesses
16 owned by the utility should be considered in mitigation. Is this sound public
17 policy?**

18 A. No. While it is important that the stranded cost recovery process encourage
19 mitigation efforts, the assets and costs relevant to mitigation should be limited
20 specifically to those of the utility business. Other businesses owned by the parent
21 company do not affect the costs of transition to competition in the electric industry
22 and should not be considered when mitigating stranded costs. Unregulated
23 business should be financially separated from regulated business in considering
24 appropriate rates. Just as losses in unregulated businesses should not be subsidized
25 by ratepayers, profits in unregulated ventures should not relieve ratepayer
26 obligations.

27 New activities into which the incumbent enters after competition begins
28 also should not figure in stranded costs, as these assets were never part of the
29 regulatory compact. Allowing profits from non-utility activities to be applied to
30 stranded costs will be seen by investors as a reduction in their return, thereby

1 discouraging incumbents from engaging in new businesses (and consequently
2 harming economic efficiency). Furthermore, such policy would increase the cost
3 of both new debt and new and existing equity capital.

4 This view is entirely consistent with my understanding (as an economist) of
5 the Supreme Court's ruling in *Brooks Scanlon Co. v. Railroad Commission of La.*,
6 in which the Court ruled that it is not permissible to judge whether rate regulation
7 is confiscatory by including the return to unregulated operations of the company in
8 question. As the Court stated, "The plaintiff may be making money from its
9 sawmill and lumber business but it no more can be compelled to spend that money
10 than it can be compelled to spend any other money to maintain a railroad for the
11 benefit of others who do not care to pay for it."²

12 13 VII. CALCULATIONS OF STRANDED COSTS

14 I. Auctions/Divestiture vs. The Net Revenue Lost Method

15 Q. Several witnesses (Rosenberg, Petrochko, Nelson and Smith) have argued
16 that so called market-based approaches (e.g., divestiture and auctions) are
17 superior to the revenue lost method. Do you agree?

18 A. No. If implemented correctly, the net revenue lost method has most, if not all, of
19 the presumed advantages of the market-based methods without some of the
20 drawbacks.

21 Q. Please describe what you believe is an appropriate implementation of the net
22 revenue lost method.

23 A. I recommend, as APS is proposing, that the stranded cost recovery charge be
24 computed year-by-year as the difference between the fixed cost recovery under
25 regulation and under market-based prices. This method has the advantage of using
26 market-based inputs, usually cited as one of the main virtues of market-based
27 methods, without the forecasting errors that will occur if a longer time period is
28 used.

² 251 U.S. 396, 399 (1920).

1 Q. What are the main drawbacks associated with alternative market-based
2 methods, such as auctions?

3 A. The main drawbacks with the auction or asset sale methods are:

- 4 1. Considerable time and expense will be required to go through the steps
5 required to conduct the auction. Consequently, until the auction is
6 completed, it will be necessary to use some other method to estimate
7 stranded costs. Also, the cost of the auction will add to the magnitude of
8 stranded costs.
 - 9 2. It will be very difficult, if not impossible, to establish the value of nuclear
10 plants through an auction process. There are substantial restrictions on the
11 transfer of ownership and operation of nuclear generation plants. I am not
12 aware of any that have been sold.
 - 13 3. There are expected to be substantial transaction costs associated with the
14 sale of plants such as paying taxes, transferring complex or interdependent
15 power supply contracts, soliciting shareholder approvals, and obtaining the
16 release of indentured property from bondholders.
 - 17 4. An inefficient auction design may distort participants' valuations of an
18 asset, thereby reducing the efficiency of this market-based mechanism.
19 Valuation of the assets can also be affected by the timing of the auctions
20 (i.e., whether the assets are sold all at once or across time).
 - 21 5. There may be other impediments to the use of market-based methods. For
22 example, market power could be increased if the sale results in greater
23 regional concentration of generation units.
- 24
25

1 2. *Capping Recovery at Replacement Cost*

2 **Q. Witnesses Higgins and Rosen recommend that total recoverable stranded**
3 **costs be calculated by using replacement cost as a proxy for market prices.**
4 **Do you agree with this recommendation?**

5 **A.** No. Any estimate of stranded costs should reflect conditions that either exist or
6 are expected to exist in the market. The replacement cost method, recommended
7 by Mr. Higgins, uses the installed cost of the most efficient generation unit in the
8 market to estimate the future price of electricity. The use of the replacement cost
9 (a proxy for long-run marginal cost) is appropriate only when the market is in
10 equilibrium, because any increase in demand will require new generation capacity
11 to be built. Moreover, the industry does not have a good track record in
12 predicting the cost or performance of future generation units.

13 In addition, the generation market is not in equilibrium and is not expected
14 to be in equilibrium for some time. In fact, as discussed in the direct testimony of
15 Jack Davis, the market is expected to have excess capacity until 2006.
16 Consequently, until the market is in equilibrium, the market price for electricity will
17 be lower than replacement cost. As a result, the use of replacement cost will
18 systematically underestimate stranded costs until supply and demand are in
19 balance. Moreover, the error occurs in the early years, where its impact on the
20 stranded costs calculation will be the greatest.

21 3. *Disallowing Returns on Equity Financing*

22 **Q. Dr. Rosenberg argues that utilities should not be allowed to earn a return on**
23 **any equity used to finance stranded costs. Do you agree with this position?**

24 **A.** No. This is a very thinly designed attempt to pick the shareholders' pockets.
25 APS's cost of capital includes equity capital. Under Dr. Rosenberg's proposal, its
26 shareholders would be denied an opportunity to earn a return on their invested
27 capital that is commensurate with its risk. As previously discussed, this would
28 amount to a taking without just compensation.

1 4. *Issuing Stock to Value Stranded Costs Would Be Ineffective and*
2 *Expensive*

3 **Q. Dr. Block and Mr. Lopezlira recommend a system in which stockholders hold**
4 **a separate class of stock that gives them a claim exclusively to stranded asset**
5 **recovery. What is your reaction to this recommendation?**

6 A. Dr. Block and Mr. Lopezlira would split existing stock into 'A' shares, standard
7 stock that provides the holder claims against the utility's future profits, and 'B'
8 shares, claims strictly against stranded cost recovery. Purchasers would pay a
9 price for 'B' shares based on what they believe to be the value of future stranded
10 cost recovery, given estimates of future market prices, production costs,
11 technological innovations, and public policy decisions. Dr. Block and Mr.
12 Lopezlira imply that this system is an effective market-based method for
13 determining the amount of stranded costs.

14 **Q. Do you agree that this system is an effective method for estimating stranded**
15 **costs?**

16 A. No. The method has numerous defects. First, at best, the method reflects the value
17 of the revenue stream associated with the regulatory process, including true-ups
18 and the risk of future changes to the regulatory mechanism, not the difference
19 between market and book value of the generation assets. Second, since the price
20 of shares of stock will be affected by factors affecting all stocks (*e.g.*, financial
21 problems in other countries and inflation announcements), the estimate of stranded
22 costs will be erroneously influenced by factors unrelated to the value of generation
23 assets. Third, the proposal appears to put payment of stranded cost recovery to
24 holders of 'B' shares of stock ahead of bond holders, preferred stock holders, and
25 holders of 'A' shares of stock. The legal or practical ability to do this is
26 questionable. Fourth, it will be difficult, if not impossible, to apply the method if,
27 as in the case of APS, the shares of stock are not publicly traded. All APS stock is
28 owned by its parent company. Finally, it is expected that there will be significant
29 transaction costs associated with issuing new shares of stock. These would
30 increase the magnitude of stranded cost recovery.

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VIII. RECOVERY MECHANISMS

1. The Recovery Period Should be As Short As Possible

Q. Mr. Coyle has suggested that the recovery period should be stretched out over a long period. Witness Rosen concurs, recommending calculating stranded costs over the period from 1998 to 2020. Do you agree?

A. No. Annual administrative calculation of the CTC would require comparing competitive costs and prices with a regulatory benchmark. As a result, these proposals would delay the onset of full competition, by keeping prices from market levels for years and requiring resources for a continuing regulatory process.

Recovering stranded costs over a shorter period of time will obviate the need for continued CTCs and will hasten the onset of a truly competitive market, bringing with it many long-term benefits to consumers and producers. Customer choice is likely to result in productive, allocative, and dynamic efficiencies that will lower costs, make prices better reflect marginal costs, stimulate technological advances, and encourage the development of new products and services. Consumers will better be able to determine what services they receive and at what prices. Further, the costs of regulation will be reduced.

Q. Dr. Rosen argues that the Commission should extend the recovery period to ensure that no consumers are made worse off by the implementation of retail access. Do you agree with this position?

A. No. While customers are likely to enjoy long-term benefits from the proper implementation of retail access, in the short run some customers may experience higher rates. Because of differences in the cost of serving customers (due to such factors as time of use, size, and load factor) and cross-subsidies inherent in the current average cost-based class rates, many customers are not charged rates that reflect the marginal or market cost of serving them. It is neither economically efficient nor desirable to guarantee that all customers will be better off under open access.

1 For economic efficiency, customers should pay the market price of the
2 service they receive. Attempting to ensure that high-cost customers are no worse
3 off under open access will mean that they pay less than the market price (marginal
4 cost of the last unit dispatched). Charging customers a price that is less than
5 marginal cost will cause them to over-consume and will prevent resources from
6 being allocated to their highest-valued use. Setting rates below market levels and
7 the marginal cost will also reduce the ability of the utility to make investments
8 required to provide safe and reliable service and to meet load growth.

9 In addition, attempting to ensure that no customer is made worse off may
10 lead to the formation of a two-tiered price system in which customers that benefit
11 from obtaining generation services from the competitive market (generally
12 customers whose cost to serve is low) will take the market option, whereas
13 customers that benefit from purchasing generation on the regulated tariff (generally
14 customers whose cost to serve is high) will pursue the regulated option. The
15 ultimate result is that the utility will be left with customers that are, on average,
16 more costly to serve.

17 Who will pay these higher costs is not clear. Customers whose cost of
18 service is above average can be charged average rates only if someone else pays
19 the bill or if the cost of service falls. The cost of service will not come down
20 quickly. Initially, the same generation units are likely to continue to supply
21 customers over the same network. Until there is sufficient time for cost savings to
22 occur, everyone cannot be better off. Consequently, under Dr. Rosen's proposal,
23 the financial viability of the utility would be threatened because the utility would be
24 unable to increase rates to subsidize the high-cost customers

25 **Q. Mr. Coyle raises the issue of intergenerational equity in this Docket. He**
26 **asserts that stranded cost recovery assesses costs to customers now, while**
27 **providing most of the benefits of competition at the end of a multi-year**
28 **transition process. If true, is this a serious problem?**

29 **A** No. While it would be desirable to closely match costs with benefits over time,
30 there are many circumstances in which this is impractical. The lack of a close

1 match in the timing of costs and benefits is not a valid reason not to proceed with a
2 project which has clear long-term net benefits. The only economic issue that the
3 difference in timing makes is whether the present value of the future benefits
4 exceeds the current costs.

5 **Q. Can you provide other examples in which inter-temporal shifts of costs and**
6 **benefits are routinely made to our mutual benefit?**

7 A. Yes. Highway construction uses federal trust funds that come largely from
8 gasoline taxes paid in the past to fund major construction projects that often
9 extend over long periods and result in capital improvements whose benefits will
10 extend over many years. Likewise, the National Institutes of Health use current
11 tax dollars to fund research which we hope will result in medical advances that will
12 help future generations. In the electric industry, the benefits from regulatory assets
13 accrued to customers in prior years, while the cost is spread out over future
14 periods.

15 Indeed, few public projects closely match costs and benefits through time.
16 While we now enjoy many of the benefits of truck, airline and telephone
17 deregulation, a great many of the costs of these changes were borne in earlier
18 periods. Matching time patterns of costs and benefits is only one issue in
19 restructuring and it is not among the most important.

20 **2. *Lump Sum Payments or Exit Fees***

21 **Q. Mr. Saline and Mr. Neidlinger recommend that customers be allowed to**
22 **make a lump sum payment for their stranded cost obligation. Do you agree?**

23 A. Yes. I agree with their recommendation that customers should be able to pay for
24 their share of the stranded costs either monthly, or as a lump sum. Paying the
25 obligation as a lump sum would appear to have the advantages of (1) reducing the
26 financing costs associated with the stranded assets, and (2) enabling customers to
27 choose the option that will minimize the present value of their costs.

1 3. *The APS Proposal Obviates the Need for a True-up Mechanism*

2 **Q. Do you agree with the argument advanced by numerous witnesses that a**
3 **true-up mechanism is required to deal with forecasting errors?**

4 **A. I do not agree that a traditional true-up mechanism, complete with hearings, is**
5 **required. I do agree that it is necessary to have some method of adjusting for**
6 **forecast errors. I believe that the APS proposal does an excellent job of**
7 **accomplishing this objective. The problem with most methods of estimating**
8 **stranded costs is that they attempt to estimate stranded costs many years into the**
9 **future. This leads to forecasting errors and the need for periodic true-ups. To get**
10 **around this problem, the APS proposal reduces the forecasting period over which**
11 **stranded costs payments are figured, eliminating the need for a true-up. As**
12 **discussed in the direct testimony of Jack Davis, APS calculates annual stranded**
13 **cost recovery charges as the difference between actual costs under cost-of-service**
14 **ratemaking and market revenues. This calculation results in a year-by-year**
15 **calculation of the margin under cost-of-service ratemaking and the margin from**
16 **market sales. This mechanism obviates the need for repeated true-up proceedings**
17 **and arguments concerning key inputs such as futures market prices and the**
18 **appropriate discount rate to use.**

19 4. *Exclusions from Stranded Cost Responsibility Should Be Few*

20 **Q. Some people argue that certain utility customers should be exempt from**
21 **paying a share of stranded costs. For example, Witness Broderick argues**
22 **that public schools should not face any stranded cost burden. How do you**
23 **respond to this proposal?**

24 **A. As long as exemptions do not reduce the total amount of stranded cost recovery,**
25 **and as long as recovery occurs via an economically sound payment mechanism, the**
26 **question of who should pay what share of the costs is ultimately a policy decision.**
27 **While Mr. Broderick apparently believes that public interest dictates that public**
28 **schools should not have to pay a share of these costs, the Commission should keep**
29 **in mind that exempting some parties requires charging remaining customers more.**
30 **Also, all parties should remember that energy deregulation will provide long-term**

1 benefits to many customers that will exceed the burden of covering stranded costs
2 for a limited number of years.

3 Mr. Broderick argues that any stranded costs paid by schools will merely
4 be passed on to residents and businesses in the form of higher taxes. However,
5 any business or organization can make the same argument. Further, Mr. Broderick
6 states that "schools with older facilities... stand to benefit the most from electricity
7 price reduction," and yet, despite these benefits, he argues that schools should be
8 exempt from transitional costs covering stranded investments.

9 Stranded cost recovery does not necessarily imply that all customers must
10 share these costs equally, and the Commission may decide to charge different
11 amounts to different parties. For example, the Commission could levy non-
12 bypassable charges proportional to past usage or predicted future benefits. As
13 long as the recovery mechanism promotes a competitive industry and keeps pricing
14 distortions to a minimum, the Commission can decide how the public interest is
15 best served by deciding on the differential impact of stranded cost recovery.

16
17 **IX. RATE FREEZES VS. PRICE CAPS**

18 **Q. Several witnesses (Rosen, Higgins) recommend the use of a price cap on**
19 **services after open-market access begins. Please comment.**

20 **A.** The principal benefits of a competitive market are the incentives it provides for all
21 participants to reduce cost through efficiency improvements and offer products
22 that better meet customer needs. The Commission should not lose sight of these
23 benefits. Any attempt to perpetuate the continuation of cost-of-service regulation
24 through price caps, rate freezes or other mechanisms should be resisted, because
25 they will impede the rapid development of competitive markets.

26 **Q. Witnesses Rosen recommends continued price regulation to ensure that no**
27 **consumer is made worse off by the transition to competition. Is this sound**
28 **public policy?**

29 **A.** No. As I mentioned previously, the principal benefits from the transition to
30 competitive markets will accrue over the long term. Any attempt to prolong
31 regulated ratemaking through a price cap or a rate freeze would delay the onset of

1 competition and distort the marketplace. If it is interested in such public policy
2 goals as shielding certain groups from the effects of a market transition, the
3 Commission would be wise to consider direct policy options, such as subsidies to
4 low-income consumers, rather than continued ratemaking, which would distort the
5 price signal.

6
7 **X. CONCLUSIONS**

8 **Q. What conclusions have you reached?**

9 A. The regulatory compact, efficiency and equity all support allowing electric utilities
10 in general, and APS in particular, to recover potentially stranded costs. This is not
11 inconsistent with competition or competitive markets and will be a major
12 contributor to quickly converting the electric industry to competition. Utilities
13 should be expected to mitigate their stranded costs, but expectations should be
14 realistic, and mitigation should not include unregulated affiliates. The net revenues
15 method, as proposed by APS, is a reasonable way to value and collect stranded
16 costs. Forced sale of assets or sale of a separate stranded investment stock have
17 serious practical drawbacks. Rate freezes and caps are inconsistent with a
18 competitive market and should be discouraged.

19 **Q. Does this conclude your testimony?**

20 A. Yes, it does.

21

JOHN H. LANDON

John Landon specializes in the application of economic and statistical principles to firms, industries and markets. Much of his work involves economic analysis for public utilities. He has managed numerous cases in the electric utility, coal, uranium, gas and computer industries, involving such issues as antitrust, competition, incentive regulation, relative firm efficiency, demand-side management, cost allocation, ratemaking, and retail and bulk power wheeling. His litigation work has involved damages assessments, forecasting, merger analysis, market definition and market power, valuation, antitrust liability, cost allocation, and pricing.

Dr. Landon has testified more than 100 times before federal district courts, state courts, the Securities and Exchange Commission, the Federal Energy Regulatory Commission, and various state commissions, and has prepared numerous expert reports and affidavits. He has authored or co-authored more than 20 articles published in academic and trade journals, two book chapters, and several monographs. His research areas include electric utilities, labor markets, vertical integration, and technological change.

Prior to joining Analysis Group Economics, Dr. Landon was Senior Vice President at NERA, Inc. Previously, he held positions as Associate Professor of Economics at the University of Delaware and Case Western Reserve University. Dr. Landon holds a Ph.D. in Economics from Cornell University.

PROFESSIONAL ACTIVITIES

Member of the Governor of Delaware's Economic Advisory Committee

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A Director of the Delaware Econometric Model Group

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Member of the American Economic Association

Associate Member of the American Bar Association

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BEFORE THE ARIZONA CORPORATION COMMISSION

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

ERRATA TO REBUTTAL TESTIMONY OF JOHN H. LANDON

FEBRUARY 20, 1998

1 Replacement: Replace page 15, lines 5-10 with:

2 **Q. Does Dr. Rose imply that consumers will not investigate competitively**
3 **provided alternatives to incumbent service offerings?**

4 **A. Yes.**

5 **Q. Do you agree with this?**

6 **A. No. Dr. Rose provides no evidence to support this view. Furthermore, consumer**
7 **behavior in actual markets overwhelmingly refutes this view. Consumers make**
8 **choices in their own best...**

9
10 Misspelling: Page 21, line 18 should read:

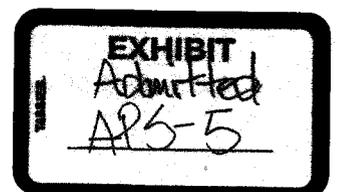
11 ...authorized equity return during 1997 would have been 31 percent, which is
12 clearly...

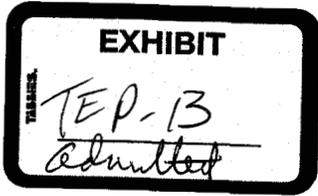
13
14 Replacement: Page 21, footnote 1 should read:

15 For an excellent discussion of the origins and history of the compact, see Chapter
16 4, "The Regulatory Contract," in J. Gregory Sidak's and Daniel F. Spulber's new
17 book Deregulatory Takings and the Regulatory Compact.

18
19 Replacement: Replace page 25, lines 15-17 with:

20 **Q. Witness Coyle argues that profits from unregulated businesses owned by the**
21 **utility should be considered in mitigation. Is this sound public policy?**





BEFORE THE ARIZONA CORPORATION COMMISSION

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

IN THE MATTER OF THE COMPETITION IN) DOCKET NO. U-0000-94-165
THE PROVISION OF ELECTRIC SERVICES)
THROUGHOUT THE STATE OF ARIZONA.) **DIRECT TESTIMONY OF**
) **KAREN G. KISSINGER**
)

On Behalf of
TUCSON ELECTRIC POWER COMPANY

JANUARY 9, 1998

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EXHIBIT A: Minutes of July 23-24, 1997 EITF Meeting Related to Issue 97-4	

1 **Introduction and Purpose**

2 Q. Please state your name and business address.

3 A. Karen G. Kissinger, 220 West Sixth Street, Tucson, Arizona 85702.

4 Q. What is your position with Tucson Electric Power Company ("Company" or "TEP")?

5 A. I am Vice President and Controller and Principal Accounting Officer. My present areas of
6 responsibility include internal and external financial reporting, plant and property accounting,
7 payroll, accounts payable, tax planning and compliance reporting, billing, credit and
8 collections. As of January 1, 1998, I am also Vice President and Controller and Principal
9 Accounting Officer of UniSource Energy Corporation, the Company's newly formed holding
10 company.

11 Q. Please describe your educational background and your business experience as the same
12 pertain to your position.

13 A. I received a Bachelor of Arts Degree in Spanish from the University of Virginia in 1977. I
14 received a Master of Business Administration with a Concentration in Accounting from the
15 University of Arizona in 1982. I am a Certified Public Accountant licensed to practice in the
16 State of Arizona. I am a member of the American Institute of Certified Public Accountants
17 and the Arizona State Society of Certified Public Accountants.

18 Before joining Tucson Electric Power Company in 1991, I was employed by Deloitte
19 Haskins & Sells and its successor by merger Deloitte & Touche in the audit department for
20 approximately eight and one half years. During that period I had both public and cooperative
21 electric utilities as audit and consulting clients. I was designated by Deloitte & Touche as a
22 public utility specialist. Since 1991, I have been employed by Tucson Electric Power
23 Company as Vice President and Controller.

24 Q. What is the purpose of your testimony in this proceeding?

25 A. The purpose of my testimony is two-fold. First, it is to respond to the December 11, 1997
26 Procedural Order requesting information in this proceeding regarding the implications of the
27 Statement of Financial Accounting Standards No. 71 ("FAS 71") resulting from
28 recommended stranded cost calculations and recovery methodologies. While the context of
29 this testimony is Issue Number 3, as defined in the December 1, 1997 Procedural Order, there

30 ...

1 are aspects of FAS 71 which have implications for all of the testimony topics requested by
2 the Procedural Order.

3 The second purpose of my testimony is to discuss certain income tax issues related to
4 Item 3 of the Procedural Order as it relates to stranded cost.

5 **Statement of Financial Accounting Standards No. 71**

6 Q. Please briefly describe the accounting requirements of Statement of Financial Accounting
7 Standards No. 71.

8 A. As rate regulated entities, TEP and certain other utilities in the state prepare their public
9 financial statements in accordance with Statement of Financial Accounting Standards No. 71,
10 *Accounting for the Effects of Certain Types of Regulation* ("FAS 71"). The underlying
11 premise of FAS 71 is that regulated enterprises should account for the economic effects that
12 result from the cause-and-effect relationship of costs and revenues in the rate-regulated
13 environment. FAS 71 defines what constitutes a cost-based rate-regulated entity and contains
14 standards of accounting for the effects of regulation. One such standard addresses the
15 method by which a regulator can create an asset by deferring, for future recovery, a current
16 cost that would otherwise be charged to expense. For that to occur, *both* of the following
17 criteria must be met:

- 18 (1) It is probable that future revenue in an amount at least equal to the capitalized cost
19 will result from inclusion of that cost in rates; and
20 (2) Based on available evidence, future revenue will be provided to permit recovery of
21 the previously incurred cost rather than to provide for expected levels of similar
22 future costs.

23 Such assets are considered to be regulatory assets. As long as the above criteria are
24 met, these regulatory assets may continue to be reflected in a utility's books and financial
25 statements. As soon as either of the above is not met, the corresponding regulatory asset
26 must be written off. To illustrate the extent to which regulatory assets impact the financial
27 reporting by a public utility, as of December 31, 1996, TEP's balance sheet included nearly
28 \$279 million in deferred regulatory assets.

29 Q. Under what conditions would FAS 71 be determined to be no longer available to a utility as
30 accounting guidance?

1 A. Utilities following FAS 71 must continually assess whether they remain regulated entities
2 under definition criteria contained in FAS 71. FAS 101, *Accounting for Discontinuation of*
3 *Application of FAS 71*, includes the following examples of situations that may warrant
4 discontinuation of FAS 71:

- 5 (1) Deregulation;
- 6 (2) A change in the regulator's approach to setting rates from cost-based ratemaking to
7 another form;
- 8 (3) Increasing competition that limits the enterprise's ability to sell utility services or
9 products at rates that will recover costs; and
- 10 (4) Regulatory actions resulting from resistance to rate increases that limit the
11 enterprise's ability to sell services or products at rates that will recover costs if the
12 enterprise is unable to obtain relief from prior regulatory actions through appeals or
13 the courts.

14 The thrust of FAS 101 is that when an enterprise ceases to meet the criteria of FAS
15 71, either in part (*i.e.*, an operating division or product line) or in total, it must discontinue its
16 application and eliminate the regulatory assets on its books that were created by regulators.
17 For TEP, the application of FAS 101 to all operations of the Company would result in a net
18 charge against net income totaling some \$157 million, based on the balances of regulatory
19 assets and liabilities as of December 31, 1996.

20 Q. Are FAS 71 and FAS 101 the only accounting guidance that are relevant to accounting for
21 regulated enterprises?

22 A. No. As innovative recovery mechanisms and incentive-based recovery plans for utilities
23 have been developed over the years, the ability of regulators to create assets by deferring
24 costs to the future has become increasingly suspect to the Financial Accounting Standards
25 Board ("FASB") and Securities and Exchange Commission ("SEC"). Accordingly,
26 additional accounting standards have been issued by the FASB to address emerging concerns
27 over accounting by regulated entities. These standards include FAS 90, *Regulated*
28 *Enterprises-Accounting for Abandonments and Disallowances of Plant Costs*; FAS 92,
29 *Regulated Enterprises-Accounting for Phase-In Plans*; and FAS 121, *Accounting for the*
30 *Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of*. Both FAS

1 90 and FAS 92 contain criteria for permitting certain plant-related costs to be deferred for
2 future rate recovery. Costs not meeting such criteria may not be deferred and must be
3 immediately expensed. FAS 121 amends FAS 71 to clarify that existing regulatory assets
4 should be written off if they are no longer considered probable of recovery. FAS 121 also
5 requires a write-off of the regulatory asset if recovery of the asset is disallowed by the
6 regulator.

7 These Standards have already had an impact on TEP. Although the Company was
8 granted authority by the Commission in previous rate cases to defer for future rate recovery,
9 certain excess capacity costs associated with Springerville Unit No. 2 (the unamortized
10 balance of which totaled \$94 million as of December 31, 1996), such deferrals failed to meet
11 the criteria set forth in FAS 92. They have been charged in their entirety to expense for
12 financial reporting purposes. No corresponding regulatory asset is reflected on the
13 Company's balance sheet prepared for financial reporting. The regulatory asset appears only
14 in the Company's regulatory balance sheet for ACC reporting purposes.

15 Q. As deregulation has emerged in various states, have these accounting standards proven to be
16 sufficient guidance to allow utilities and their regulators to interpret the implications and act
17 accordingly?

18 A. Unfortunately, no. FAS 71 did not contemplate deregulation in quite the ways we see
19 unfolding across the nation today. Transition plans, competitive transition charges,
20 securitization of stranded asset costs, and other innovations simply were not forecast when
21 FAS 71 was written. As a result, the Emerging Issues Task Force ("EITF"), a committee of
22 the Financial Accounting Standards Board, met in the summer of 1997 to deal with some of
23 the issues now arising in deregulation. In July 1997, the EITF issued a consensus position,
24 *Issue 97-4, Deregulation of the Pricing of Electricity, Issues related to the Application of*
25 *FASB Statements No. 71, Accounting for the Effects of Certain Types of Regulation, and No.*
26 *101, Regulated Enterprises – Accounting for the Discontinuation of Application of FASB*
27 *Statement No. 71.* The minutes of the July 23-24, 1997 EITF meeting related to issue 97-4
28 are attached as Exhibit A.

29 Q. Briefly, what specific issues does EITF 97-4 address?

30 A. EITF 97-4 provides guidance as to when an entity facing deregulation should discontinue

1 following the provisions of FAS 71 and some of the mechanics of how to discontinue FAS
2 71. EITF 97-4 states that accounting under the guidance of FAS 71 should be discontinued
3 for a separable portion of a business when legislation or a public utility commission order
4 that contains sufficient detail to reasonably determine how a transition plan will affect the
5 deregulated portion of the business is issued. Regulatory assets and liabilities remain on the
6 financial records of the business if they are recoverable through "regulatory cash flows" until:

- 7 (1) The assets are recovered and/or the liabilities are settled through the collection of
8 "regulatory cash flows";
9 (2) The assets become individually impaired, or the regulator eliminates the obligation;
10 or
11 (3) The separable portion of the business from which the "regulated cash flows" are
12 derived no longer meets the criteria to continue accounting in accordance with the
13 provisions of FAS 71.

14 Costs of the deregulated business may be deferred if they are expensed or incurred
15 after FAS 101 is applied and such costs are recoverable through "regulatory cash flows."

16 Q. How does EITF 97-4 define "regulatory cash flows?"

17 A. "Regulatory cash flows" are rates charged to customers intended by regulators to recover the
18 specified regulatory assets. The cash flows are derived from a levy on regulated goods or
19 services provided by a separable portion of the business that continues to meet the criteria to
20 account for its activities in accordance with the provisions of FAS 71.

21 Q. What is the status of the rules adopted by the Commission to date insofar as EITF 97-4 would
22 define the point in time at which a utility must cease to follow the guidance of FAS 71 for its
23 generation operations?

24 A. To date, there is insufficient specificity in the rules to cause the Arizona utilities to cease
25 following the tenets of FAS 71 for generation operations. As soon as the rules contain
26 sufficient information for the utilities to reasonably estimate the impact of the deregulation
27 rules on their operations, the utilities may have to cease accounting for their generation
28 operations in accordance with FAS 71. I presume that this may result from these stranded
29 cost proceedings.

30 ...

1 Q. What are the implications of these accounting rulings on the determination of the stranded
2 cost recovery mechanism in Arizona?

3 A. Even though the generation portion of the utility may no longer be able to follow the
4 provisions of FAS 71, the regulatory assets and other stranded costs which initially evolved
5 as a part of the generation side of the business are not necessarily written off the books at the
6 date that the generation business ceases to qualify to account for its operations in accordance
7 with FAS 71. So long as a part of the business, such as the distribution portion of the
8 business, remains cost-based rate regulated, and such business has the regulated cash flows to
9 recover the costs of the regulatory assets and other stranded costs, those costs are not written
10 off. However, certain conditions apply. If the conditions are not met, write-offs will occur.

11 Q. What are the conditions?

12 A. EITF 97-4 is clear in its expectation that the cash flows must come from regulated revenues,
13 rather than competitive revenues, even if it is probable that such competitive revenues will be
14 earned by the entity. The cash flows can come from rates charged directly as a tariffed rate,
15 or as a competitive transition charge, or through proceeds from securitized bonds which will
16 be paid off through regulated revenues. In addition, the cash flows have to be certain enough
17 to warrant reliance upon them as a recovery mechanism.

18 Q. Please explain "certain enough".

19 A. Unfortunately, that determination will likely be completely dependent upon individual facts
20 and circumstances. In general, accountants speak in terms of costs being "probable of
21 recovery." In an accounting sense, that means recovery is "likely" to occur. From
22 conversations with senior utility personnel at Big Six accounting firms, and information I
23 have received through my participation on the Edison Electric Institute Accounting Executive
24 Advisory Committee, I have learned that accounting staff at the SEC as well as other
25 accounting professionals express concern that some of the stranded cost recovery plans being
26 developed in various states provide inadequate recovery mechanisms.

27 Q. What are some of the specific concerns raised by accounting professionals?

28 A. Accounting professionals express concerns about recovery periods extending many years into
29 the future, beyond the end of the so-called transition plans, and recovery methods without
30 true-up mechanisms. If a recovery plan has no "true-up" mechanism provided during the

1 recovery period, the stated rate path would need to have sufficient "head room" for allowable
2 regulated costs to increase (such as for inflation) and still provide for recovery of the stranded
3 cost within the provided recovery period.

4 Q. Explain what you mean by a "true-up" mechanism, and what features such mechanism would
5 need to have.

6 A. A true-up mechanism is a "re-opener" provision in the cost recovery plan which allows the
7 parties to assess whether the original recovery path provided too much, or too little, recovery
8 of the identified recoverable stranded costs. A true-up provision that is a one-way street,
9 only allowing the regulator to end the recovery path early, if the regulator deems that the
10 costs would be recovered sooner than originally anticipated does not provide sufficient
11 support. To be a meaningful true-up provision for accounting purposes, such true-up
12 mechanism would need to allow for upward adjustments as well as downward adjustments.
13 The true-up mechanism would allow the utilities to increase their recovery, if the original
14 recovery path was determined to be insufficient to fully recover the allowable stranded costs.

15 Q. What are specific implications for recovery plans in Arizona?

16 A. The more risk that a utility is asked to assume in achieving the cash flows to recover the
17 stranded costs, the less likely that the recovery plan provides adequate assurance that the
18 costs will be recovered, and therefore, recognized on the balance sheet for financial reporting
19 purposes. Consensus among the accounting firms appears to be that recovery periods of five
20 years or less, or about the same time period as the transition period, appear to provide
21 sufficiently timely recovery for the regulator to ensure that the utility receives its cost
22 recovery. If the plan provides for recovery over a five to ten year period, the plan *may* be
23 considered adequately timely, but considerable doubt exists as to whether recovery over a
24 period in excess of ten years would be sufficiently timely. The longer the recovery period,
25 the greater the need for a true-up mechanism to allow the utility's cost recovery to be re-
26 evaluated and modified. In the alternative, a greater amount of "head room" within the rate
27 or increased evidence that the costs will be recovered by the end of the stated recovery period
28 would be needed.

29 ...

30 ...

1 Q. Does the specific recovery calculation method chosen make a difference, in determining
2 whether the amounts are recognized as recoverable for FAS 71 financial statement
3 presentation purposes?

4 A. No. With any method of calculation of recovery, whether it is net lost revenues, replacement
5 cost valuation, auction and divestiture, stock market valuation, or some other method not yet
6 discussed in the competition docket, the method of calculation is not the issue. The issue is
7 really the cash flows expected to be derived under the plan. In each case, the amount of cash
8 flows provided by the method is initially determined and then compared to the balances of
9 costs that the cash flows are specifically earmarked to recover. Recoverable amounts remain
10 regulatory assets/liabilities of the remaining regulated entity.

11 Q. Please explain how the adequacy of regulatory cash flows is determined, in general terms.

12 A. First, the utility must determine the regulatory cash flows expected to be recovered over the
13 life of the regulatory asset or stranded cost. If the gross cash inflows less the gross cash
14 outflows, if any, that relate to such regulatory asset or stranded cost exceed the carrying
15 amount of the regulatory asset or stranded cost, then no write-down occurs. If the net cash
16 flows is less than the recorded book value, a write-down will occur.

17 The regulatory asset is written down to its estimated recoverable amount, as of the
18 date that the impairment is determined. Other stranded costs, such as plant costs, would be
19 written down to their fair values, pursuant to FAS 121. The fair value (as defined in FAS
20 121) would be determined using quoted market prices for similar assets or other valuation
21 models. Valuation models might include the present value of the estimated expected future
22 cash flows using a discount rate commensurate with the risks involved, option-pricing
23 models, matrix pricing, option-adjusted spread models, and fundamental analysis. Losses
24 incurred due to the disallowance of certain kinds of stranded costs, such as abandoned plants,
25 would be calculated in accordance with FAS 90.

26 Q. If the regulatory recovery plan ultimately approved for the Company does not provide
27 specific indications of which assets are being allowed for recovery and which are not, are
28 there accounting ramifications?

29 A. Yes. The above-described cash flow analysis presumes that an entity knows the specific
30 costs for which it is being provided recovery. In the methods discussed to date in the

1 competition docket and in most other states, there is little attempt to designate the stranded
2 cost recovery dollars to specific assets. For example, in the net lost revenues approach, the
3 regulator may determine that in aggregate \$250 million represents the stranded cost; the
4 methodology does not specifically match each cost on the balance sheet to each dollar in the
5 recovery path. This requires the utility to use its best judgment in allocating the cash flows
6 among fixed assets such as above-market utility plant and any regulatory assets to perform
7 the cash flow analysis.

8 Q. Are there other FAS 71 consequences for the generation side of the business?

9 A. Yes. At the point in time that the generation portion of the business becomes deregulated,
10 the generation portion of the business can no longer account for its activities in accordance
11 with FAS 71. Therefore, it must review the carrying values of all of its long-lived assets,
12 such as utility plant, to determine whether the values are appropriate for enterprises in
13 general. Enterprises in general must carry their long-lived assets at historical cost unless the
14 value is impaired. Pursuant to the provisions of FAS 121, the utility would need to estimate
15 the cash flows expected to result from the use of the asset over its expected useful life and its
16 eventual disposition, both inflows and outflows. If the net cash inflow is less than the
17 carrying amount of the asset, the asset would be written down to its fair value. The loss
18 would be calculated as the difference between the fair value of the asset and the carrying
19 amount of the asset. Fair value would be determined as noted earlier in this testimony.

20 **Income Tax Issues to be Considered in the Determination of Stranded Costs**

21 Q. Should the calculation of stranded costs to be recovered include regulatory assets related to
22 income taxes?

23 A. Yes, the amount of stranded costs to be recovered should include regulatory income tax
24 assets. In prior years when utility assets were placed in service, certain tax benefits were
25 flowed-through to ratepayers, thus reducing income tax expense charged to ratepayers.
26 Regulated utilities have been able to record regulatory assets related to these benefits because
27 it was understood that the utility would recover these benefits in future rates over the
28 depreciable life of the asset. To the extent not all of these tax benefits have been recovered, a
29 regulatory asset is recorded on the utility's books for the amount of pretax revenues

30 ...

1 necessary to allow the utility to recoup this benefit. The utilities expect to recover these
2 amounts in accordance with the regulatory compact.

3 Q. If the utility is not allowed to recover these regulatory income tax assets in rates, what will be
4 the impact on the accounting records of the utility?

5 A. When these regulatory assets were initially established there was no income statement impact
6 for the utility. The assets were originally recorded via a charge, or addition, to the regulatory
7 asset account for the amount of pretax revenues to be collected, and a credit, or increase, to
8 deferred tax liability. These income tax regulatory assets amounted to \$174 million at
9 December 31, 1996 for the Company. If the regulatory income tax asset is not allowed to be
10 collected from ratepayers, it would have to be written off from the balance sheet of the utility.
11 However, FAS 109, *Accounting for Income Taxes*, still requires that the utility record the
12 amount of deferred tax due the Internal Revenue Service ("IRS") in the future due to the tax
13 deductions given to ratepayers in prior years. Since the write-off of the regulatory income
14 tax assets could not be accomplished by a reversal of the initial entry establishing the assets,
15 the impact would be a net charge, or reduction, to the book income of the utility. The amount
16 of this charge would be the after-tax amount of the utility revenues which would not be
17 collected from ratepayers. There would be no current deduction allowed on the Federal or
18 State income tax return of the utility for this loss of revenues.

19 Q. Will a public utility still be subject to the normalization requirements of the Internal Revenue
20 Code if it is not allowed to recover 100% of its stranded costs?

21 A. It is unclear how the IRS would handle the normalization requirements for a utility that is not
22 allowed to recover 100% of its stranded costs. The IRS has provided guidance in the case of
23 specific assets which are no longer subject to regulation, but not in the case of an overall
24 disallowance which may apply to some or all of a utility's assets. In the case of specific
25 identification of deregulated assets, the IRS has ruled that none of the tax benefits associated
26 with the deregulated assets may be taken into consideration when determining the rates to be
27 charged for the assets which are still regulated. The rulings provided that the regulators may
28 not reduce rate base for the deferred tax liabilities associated with the deregulated assets, and
29 that cost of service calculations may not reflect a tax deduction for depreciation on the
30 deregulated assets.

1 Q. Should income taxes to be paid on stranded cost recovery be taken into consideration in the
2 calculation of stranded costs?

3 A. Yes. When the utility collects the revenues designated to recover stranded costs, they will be
4 required to pay income taxes on the amounts collected for both Federal and State income tax
5 purposes. As a result, in order to be made whole, the utility must receive sufficient revenues
6 to pay the taxes and still recover their investment. This is no different than the current
7 methodology used to calculate revenue requirements, which takes into consideration the
8 taxability of the revenues to be collected.

9 Q. Is there an income tax deduction for Federal or State income tax purposes associated with the
10 inability to fully recover stranded investment?

11 A. No. The Internal Revenue Code does not provide for any deductions for the impairment of
12 assets. A taxpayer may only take a deduction for the loss of an asset if the asset is
13 permanently abandoned or disposed of at a loss. In the case of generating facilities which
14 must continue to be operated despite an inability to recover their stranded cost component,
15 there would be no deduction available. The utility would continue to depreciate that
16 generating facility under the existing method elected for income tax purposes.

17 Q. Does the Auction and Divestiture method of computing stranded costs present any particular
18 income tax issues?

19 A. Yes, it does. Because of the use of accelerated depreciation for income tax purposes, most
20 utility assets will have a tax basis which is lower than book basis. As a result, the utility will
21 generally experience a larger gain, or reduced loss, for tax purposes than for book purposes.
22 Under the Auction and Divestiture proposal, the amount of stranded costs to be recovered by
23 the utility would be deemed to be mitigated to the extent there was income from the sale of
24 the generating assets. If this methodology is authorized, care must be taken to ensure that
25 only the after-tax income is treated as a mitigation of the stranded costs. To the extent that
26 ratepayers have benefited in the past from the accelerated deductions which led to the lower
27 tax basis, they should be required to pay the income taxes incurred as a result of those
28 deductions when the asset is sold. This "payment" would be made via a reduction in the
29 amount of stranded costs treated as mitigated as a result of the sale of the assets.

30 ...

1 **Recommendation**

2 Q. Ms. Kissinger, given all of the information included in your testimony, what is your specific
3 recommendation for a stranded cost recovery plan in Arizona that complies, to the best of
4 your knowledge and belief, with the accounting literature that you cite, so that no losses are
5 incurred?

6 A. The recovery plan must include recovery of 100% of stranded costs, including all income tax
7 regulatory assets and the income tax ramifications, of the recovery mechanism chosen. The
8 recovery plan should provide for recovery of the stranded costs over a period of
9 approximately five years, and should include a true-up mechanism which allows for
10 additional amounts of stranded costs to be collected, in the event that facts and circumstances
11 at the time of the true up indicate that the recovery path initially established will be
12 inadequate for the full amount of stranded costs to be recovered.

13 Q. Please explain how your recommendation and Mr. Bayless' proposed stranded cost recovery
14 plan are compatible.

15 A. Mr. Bayless proposes 100% recovery of stranded costs with immediate recovery in cash for
16 the utility of approximately 75% of the costs through securitization and recovery of the
17 remaining approximately 25% non-securitized stranded cost by the end of 2004 through a
18 Competitive Transition Charge ("CTC"). The consumers would then provide the funds to
19 repay the bonds securitizing stranded costs over a 10- to 15- year period. The plan further
20 provides for a true-up mechanism which recalibrates the CTC at any time when the band
21 ceiling or floor is exceeded. This plan provides cash recovery to the Company of 100% of its
22 stranded cost over six years, consistent with my proposed approximately five years, and
23 includes a true-up mechanism that allows for increases in recovery by the Company in the
24 event that facts and circumstances at the time of the true up indicate that the recovery path
25 initially established will be inadequate for the full amount of stranded costs to be recovered.
26 Without a securitization plan, it would appear difficult to accomplish recovery of the stranded
27 costs in a period of approximately five years.

28 Q. Does this conclude your testimony?

29 A. Yes, it does.

30

Section: Issue 97-04 - Deregulation of the Pricing of Electricity - Issues Related to the Application of FASB Statements No. 71, Accounting for the Effects of Certain Types of Regulation, and No. 101, Regulated Enterprises—Accounting for the Discontinuation of Appl

Subsection: A. Abstract/Minutes

E 2. Issue 97-4 - July 23-24, 1997

Date Composed: 08/12/97

Date Modified:

Issue No. 97-4

Title: Deregulation of the Pricing of Electricity—Issues Related to the Application of FASB Statements No. 71, *Accounting for the Effects of Certain Types of Regulation*, and No. 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71*

Introduction

1. Several state legislatures and/or regulatory commissions have recently approved, and others including federal legislators are currently considering, changes to laws and regulations governing the pricing of electricity. Specifically, those changes relate to the element of the total price of a kilowatt of electricity that is intended to cover its production ("generation") cost, as opposed to the portion intended to cover the transmission cost to a local area or the portion intended to cover the cost of distribution to individual residences or businesses.
2. The nature of these regulatory changes has been to move away from a pricing model that has prices set by a regulator based on allowable cost toward and ultimately to a pricing model that has prices set by competitive market forces. Because market-based prices are ultimately expected to be lower than the former allowable cost-based regulated pricing, the impact of these regulatory changes on companies that generate electricity has been to transform some of their investment in generation operations into what has been referred to as "stranded costs."
3. FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation*, specifies three criteria that must be met in order to reflect the effects of rate regulation in a regulated enterprise's financial statements. If all of the criteria are met, the enterprise will recognize assets and liabilities that are not recognized by enterprises in general. These assets and liabilities are often referred to as "regulatory assets and liabilities."¹¹ Throughout this Issue, reference is made to "regulatory assets" and "regulatory liabilities." "Regulatory assets" and "regulatory liabilities" are those assets and liabilities recognized pursuant to the provisions of paragraphs 9 and 11, respectively, of Statement 71. These assets and liabilities are not recognized by enterprises in general. An example of a regulatory asset is the cost incurred to repair damage from an ice storm, if the regulator provides that these specific expenditures will be recovered from customers by inclusion of that cost in the determination of future rates. An

example of a regulatory liability is a gain on the early extinguishment of debt if the regulator provides that this specific gain will be passed through to customers by inclusion of that gain in the determination of future rates. If some of an enterprise's operations are regulated and other operations are not, then Statement 71 should be applied to the portion of an enterprise's operations that meets the three criteria. FASB Statement No. 101, *Regulated Enterprises—Accounting for the Discontinuation of Application of FASB Statement No. 71*, addresses how an enterprise that ceases to meet the criteria for application of Statement 71 to all or part of its operations should report that event in its general-purpose financial statements.

Issues

4. The issues are:

- a. When an enterprise should stop applying Statement 71 to the separable portion of its business whose product or service pricing is being deregulated once legislation is passed or a rate order is issued (whichever is necessary to effect change in the jurisdiction) that has the effect (either immediately or at some point in the future) of deregulating the rates charged to customers.
- b. How an enterprise should evaluate whether to continue to recognize all or some portion of the "regulatory assets" and "regulatory liabilities," respectively, that (1) originated from the separable portion of the business whose pricing is being deregulated and (2) exist at the date Statement 101 is applied.
- c. How an enterprise should evaluate whether to establish additional "regulatory assets" and "regulatory liabilities" related to expenses and obligations, respectively, that will originate from the separable portion of the business whose pricing is being deregulated but that will arise subsequent to applying Statement 101.

Prior EITF Discussion

5. At the May 21-22, 1997 meeting, individuals familiar with the electric utilities industry presented an educational session that included background information on the industry, the nature of the current deregulatory initiatives, and the accounting framework for regulated enterprises.

6. The Task Force reached a tentative conclusion that the continued recognition of "regulatory assets" and "regulatory liabilities" of the separable portion of a business to which Statement 101 is being applied should be determined on the basis of where (that is, the portion of the business in which) the regulated cash flows to realize and settle them, respectively, will be derived. "Regulated cash flows" are from rates charged to customers that are intended by regulators to be for the recovery of "regulatory assets" and the settlement of "regulatory liabilities."

7. The Task Force noted that Statement 71, as amended by FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, provides specific guidance to regulated entities on impairment of regulatory assets.

8. The Task Force discussed how the criteria for application of Statement 71 should be evaluated in the context of a deregulation plan but was not asked to reach a consensus.

Current EITF Discussion

9. On Issue 4(a) the Task Force reached a consensus that when deregulatory legislation or a rate order (whichever is necessary to effect change in the jurisdiction) that contains sufficient detail for the enterprise to reasonably determine how the transition plan will effect the separable portion of its business whose pricing is being deregulated is issued, the enterprise should stop applying Statement 71 to that separable portion of its business. The Task Force did not address whether an enterprise should stop applying Statement 71 to that separable portion of its business prior to the issuance of sufficiently detailed deregulatory legislation or a sufficiently detailed rate order.

10. The Task Force observed that once Statement 71 is no longer applied to a separable portion of an enterprise's business, the financial statements should segregate, via financial statement display or footnote disclosure, the amounts contained in the financial statements that relate to that separable portion.

11. On Issue 4(b) the Task Force reached a consensus that the "regulatory assets" and "regulatory liabilities" that originated in the separable portion of an enterprise to which Statement 101 is being applied should be evaluated on the basis of where (that is, the portion of the business in which) the regulated cash flows to realize and settle them, respectively, will be derived. "Regulated cash flows" are from rates that are charged to customers and intended by regulators to be for the recovery of the specified "regulatory assets" and the settlement of "regulatory liabilities." They are derived from a "levy" on rate regulated goods or services provided by another separable portion of the enterprise that meets the criteria for application of Statement 71.

12. The result of the consensus on Issue 4(b) is that the "regulatory assets" and "regulatory liabilities" that originated in the separable portion of the business to which Statement 101 is being applied and for which the deregulatory legislation or rate order (whichever is necessary to effect change in the jurisdiction) specifies the collection of "regulated cash flows," are not eliminated until:

a. They are recovered by (in the case of assets) or settled through (in the case of liabilities) collection of regulated cash flows, or

b. They are individually impaired (in the case of assets) or the regulator eliminates the obligation (in the case of liabilities) as specified by the provisions of Statement 71, as amended by Statement 121, or

c. The separable portion of the business from which the regulated cash flows are derived no longer meets the criteria for application of Statement 71.

13. On Issue 4(c) the Task Force reached a consensus that the "source of the cash flow" approach adopted in the consensus to Issue 4(b) should be used for recoveries of all costs and settlements of all obligations (not just for "regulatory assets" and "regulatory liabilities" that are recorded at the date Statement 101 is applied) for which regulated cash flows are specifically provided in the deregulatory legislation or rate order, (whichever is necessary to effect change in the jurisdiction.)

14. The result of the consensus on Issue 4(c) is that a cost or an obligation is recognized as a "regulatory asset" or a "regulatory liability" within the separable portion of the enterprise from which the regulated cash flows for its recovery or settlement, respectively, are derived once it is:

a. Expensed or incurred after Statement 101 is applied to the portion of the business where it originated (such as the loss on the sale of an electricity generating plant or the loss on the buy-out of a purchased power contract that is recognized after Statement 101 is applied to the generation portion of the business); and

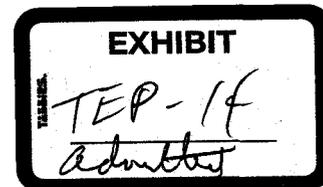
b. Specified for recovery or settlement in the deregulatory legislation or a rate order (whichever is necessary to effect change in the jurisdiction) and is recovered or settled in the same manner (that is, via "regulated cash flows") as the "regulatory" assets and "regulatory" liabilities described in the consensus to Issue 4(b).

Those "regulatory assets" and "regulatory liabilities" are carried in this other separable portion of the business until they are collected or settled, or individually impaired (assets) or eliminated (liabilities), or until that separable portion of the business no longer meets the criteria for application of Statement 71.

Status

15. No further EITF discussion is planned.

DIRECT TESTIMONY OF KAREN G. KISSINGER
SUMMARY



Implications of Financial Accounting Rules Pertinent to Stranded Cost Recovery Plans

To date, there is insufficient specificity in the rules adopted in December 1996 to cause the Arizona utilities to cease following the tenets of Statement of Financial Accounting Standards No. 71 (FAS 71) for generation operations. As soon as the rules contain sufficient information for the utilities to reasonably estimate the impact of the deregulation rules on their operations, the utilities may have to cease accounting for their generation operations pursuant to FAS 71.

With any method of calculation of stranded cost recovery, whether it is net lost revenues, replacement cost valuation, auction and divestiture, stock market valuation, or some other method not yet discussed in the competition docket, the method of calculation does not impact whether the method precludes or causes write-offs under FAS 71. The issue is really the cash flows expected under the plan. In each case, the amount of cash flows provided by the method is initially determined and then compared to the balances of costs that the cash flows are specifically earmarked to recover. Recoverable amounts remain regulatory assets/liabilities of the remaining regulated entity. Amounts that are not recoverable through the collection of regulatory revenues are written off.

The more risk that a utility is asked to assume in achieving the cash flows to recover the stranded costs, the less likely that the recovery plan provides adequate assurance that the costs will be recovered, and therefore, recognized on the balance sheet for financial reporting purposes. Recovery periods of five years or less, or about the same time period as the transition period, appear to provide sufficiently timely recovery for the regulator to ensure that the utility receives its cost recovery. If the plan provides for recovery over a five to ten year period, the plan *may* be considered adequately timely, but considerable doubt exists as to whether recovery over a period in excess of ten years would be sufficiently timely. The longer the recovery period, the greater the need for a true-up mechanism to allow the utility's cost recovery to be re-evaluated and modified, or a greater amount of head room within the rate, or increased evidence that the costs will be recovered by the end of the stated recovery period.

To be a meaningful true-up provision for accounting purposes, a true-up mechanism must allow for upward adjustments as well as downward adjustments. The true-up mechanism would

allow the utilities to increase their recovery, if the original recovery path was determined to be insufficient to fully recover the allowable stranded costs.

Income Tax Considerations for Stranded Cost Recovery Plans

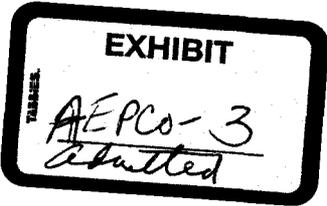
The amount of stranded costs to be recovered should include regulatory income tax assets. In prior years when utility assets were placed in service, certain tax benefits were flowed-through to ratepayers, thus reducing income tax expense charged to ratepayers. To the extent not all of these tax benefits have been recovered, a regulatory asset is recorded on the utility's books for the amount of pretax revenues necessary to allow the utility to recoup this benefit. The utilities expect to recover these amounts in accordance with the regulatory compact.

It is unclear how the Internal Revenue Service would handle the normalization requirements for a utility that is not allowed to recover 100% of its stranded costs. In the case of specific identification of deregulated assets, rulings provide that the regulators may not reduce rate base for the deferred tax liabilities associated with the deregulated assets, and that cost of service calculations may not reflect a tax deduction for depreciation on the deregulated assets.

When the utility collects the revenues designated to recover stranded costs, the utility will be required to pay income taxes on the amounts collected for both federal and State income tax purposes. As a result, in order to be made whole, the utility must receive sufficient revenues to pay the taxes and still recover their investment. This is no different than the current methodology used to calculate revenue requirements, which takes into consideration the taxability of the revenues to be collected.

Recommendation:

For the utilities to avoid recording write offs under FAS 71 as a result of the stranded cost recovery plan, the recovery plan must include recovery of 100% of stranded costs, including all income tax regulatory assets and the income tax ramifications of the recovery mechanism chosen. The recovery plan should provide for recovery of the stranded costs over a period of approximately five years, and should include a true-up mechanism which allows for additional amounts of stranded costs to be collected, in the event that facts and circumstances at the time of the true up indicate that the recovery path initially established will be inadequate for the full amount of stranded costs to be recovered. The stranded cost recovery plan proposed by Mr. Bayless is consistent with my recommendation.



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BEFORE THE ARIZONA CORPORATION COMMISSION

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

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

TESTIMONY OF
DIRK C. MINSON
ON BEHALF OF
THE ARIZONA ELECTRIC POWER COOPERATIVE, INC.

JANUARY 9, 1998

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TESTIMONY OF
DIRK C. MINSON
ON BEHALF OF
THE ARIZONA ELECTRIC POWER COOPERATIVE, INC.
DOCKET NO. U-0000-94-165

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electric needs in their respective certificated areas. These all requirements contracts currently extend through the year 2020.

- Q. How does AEPCO meet the power needs of its members?
- A. Primarily through 520 MW of coal and gas fired generation at our Apache Generating Station located near Wilcox, Arizona. However, AEPCO also has short and long-term purchase contracts with other utilities that it uses to meet these needs.

- Q. What is AEPCO's position on the recovery of stranded costs?
- A. AEPCO was formed to provide bulk generation and transmission service for its member distribution cooperatives. The Apache Station, along with a transmission system, was built to satisfy this need. Costs for these facilities were expended to ensure that the distribution cooperatives would have power at the lowest reasonable cost with high reliability. These costs have been approved by the ACC as prudently expended in prior rate hearings. AEPCO finances its generation and transmission facilities strictly through debt. Full recovery of "stranded costs" as a result of implementation of the electric competition rules in the state of Arizona is mandatory. Any significant losses as a result of unrecovered stranded cost may jeopardize AEPCO's debt and severely restrict AEPCO's ability to raise capital in the future.

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Q: What is the purpose of your testimony?

A: The purpose of my testimony is to provide AEPCO's position on the nine issues concerning Stranded Costs which were set forth in the Procedural Order in this matter dated December 1, 1997. AEPCO is also offering the testimony of Mr. David Hedberg of the National Rural Utilities Cooperative Finance Corporation (CFC) in relation to several of these matters.

Q: Have you attempted to rank by order of importance the issues of most concern to AEPCO?

A: Yes. Consistent with the Hearing Officer's request, I will address first the issues of most importance to AEPCO. However, I would stress that all issues identified in the December 1, 1997 Procedural Order are of considerable importance to AEPCO. Therefore, I do not mean to minimize an issue's overall importance by discussing it later rather than earlier in my testimony.

CALCULATION METHODOLOGY

Q: The third issue identified in the Procedural Order is "What costs should be included as part of 'stranded costs' and how should those costs be calculated?" The Hearing Officer subsequently indicated that calculation methodology, market clearing price and SFAS 71 implications should be addressed in relation to this issue. Starting with calculation methodology, please state AEPCO's position.

A: AEPCO strongly supports the use of the "net revenues lost" methodology for calculation of stranded cost. This methodology

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was discussed at pages 20 - 22 and 27 - 28 of the Stranded Cost Working Group Report. This method has a number of advantages associated with it. With particular reference to AEPCO as a generation and transmission cooperative, AEPCO believes it is best suited to identify and allow recovery of stranded costs associated with our mortgage and the all requirements contracts we have with our Class A members. We do believe the Commission should amend its Competition Rules to state the filing requirements necessary to support a "net revenues lost" calculation filing.

Q. Please state AEPCO's view of Statement of Financial Accounting Standard (SFAS) No. 71, Accounting for the Effects of Certain Regulation, as it pertains to stranded cost recovery.

A. SFAS No. 71 allows for certain regulatory assets to be established by a utility if those amounts have been approved for recovery over a specified period of time by the utility's regulator. AEPCO uses this accounting standard for certain regulatory assets which have been approved for recovery by the Commission in prior rate hearings. Care must be taken by the Commission when addressing stranded cost recovery. Clear and precise language in any Stranded Cost Order will allow continued adherence to SFAS No. 71 standards by Arizona utilities and will avoid precipitous and unnecessary write-offs by utilities.

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Q. Please state AEPCO's position on market clearing price matters.

A. Market clearing price is a very complicated subject and predicting it over even a short period of time is difficult. This reality is an additional argument in favor of a true-up mechanism which I'll discuss next. In general, AEPCO believes that the appropriate price by which to gauge stranded costs is the long-term marginal price. Although short and intermediate price estimates should also play a role in this determination, the long-term marginal price represents investment in an electrical system that was built under the concept of obligation to serve. A longer term price is not as subject to temporary market fluctuations and reflects the reality that in the future all power cannot and will not be sold at the short term marginal cost. Finally, use of a longer term price will (1) minimize stranded costs, (2) make full recovery more palatable and (3) avoid possible asset write-offs if stranded costs are overstated.

TRUE-UP MECHANISM

Q: Please state AEPCO's position on a true-up mechanism.

A: AEPCO believes a true-up mechanism would be appropriate. As a non-profit customer-owned generation and transmission cooperative, such a mechanism would help to ensure that stranded costs are neither over nor under recovered. We envision a true-up mechanism working much like a purchased power and fuel adjustment clause. Certain benchmarks would be

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established during the utility's specific stranded cost determination proceeding and regular filings would then be made to provide the Commission information as to stranded cost recovery in relation to those benchmarks. Every two years a true-up could be accomplished, if necessary. Finally, we recommend that any true-up procedure be streamlined. Ideally, unless there is some dispute concerning the utility's filing, the true-up could be accomplished by the Commission at Open Meeting without the necessity of a hearing.

LIMITATIONS

Q: The Procedural Order identified three issues (No's. 4, 5 and 8) requesting positions on various limitation suggestions. Let's begin with AEPCO's position on whether there should be a limitation on the timeframe over which "stranded costs" are calculated.

A: There should not be any Rules' limitation on the timeframe over which stranded costs are calculated. In AEPCO's case, its "all requirements" contracts terminate in the year 2020. The estimated used and useful lives of most of its generating and transmission assets extend beyond this period. Keeping in mind that there is no AEPCO stockholder class nor any equity against which to bank or cushion unrecovered stranded costs, it is important to allow calculation of stranded costs, at a minimum, over the term of the all requirements contracts and, at a maximum, over the used and useful lives of the assets which

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were financed and constructed to support those obligations.

Q: What is AEPCO's position on a limitation on the recovery timeframe for stranded costs?

A: AEPCO does not believe that the Commission should establish any generic limit on the recovery timeframe for stranded costs. This issue should be left to utility specific stranded cost proceedings. The principle danger in adopting a fixed limit on recovery timeframe, i.e. seven or ten years, is that it will increase stranded cost recovery in the early years, correspondingly increasing rates which must be charged currently and perhaps creating artificial barriers to the competitive market.

Q: Finally, does AEPCO believe there should be price caps or a rate freeze imposed as part of the stranded cost recovery program?

A: No. Although I am not an attorney, I do not believe any legal basis exists for such a price cap or rate freeze. As an equitable matter, the Commission's Rules impose a continuing duty and obligation to serve any customer which either elects not to participate in the competitive market or does not have available competitive choices. Rates must be sufficient to support these and other ongoing service needs. Over the past ten years, AEPCO has decreased its Class A member rates by more than twenty percent. We hope to continue these rate reductions or at least maintain rate stability in the future. However, an

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arbitrary price cap or rate freeze would be just that and should not be imposed.

STRANDED COST FILING TIMING

Q: When does AEPCO feel it can make a stranded cost filing pursuant to R-14-2-1607?

A: At this time, I cannot answer that question because so many variables such as market clearing price and calculation methodology remain undefined by the Commission.

WHO SHOULD PAY

Q: Currently, the Competition Rules provide that stranded costs will be recovered only from customers participating in the competitive market. What is AEPCO's position on this issue?

A: All customers should pay stranded costs on a system by system basis. Apparently, the Commission has made a determination that competition will be in all customers', and the public's, best interest. Given that, all customers are beneficiaries of this public policy and therefore should bear the costs associated with it. Further, by spreading stranded costs over all customers on a system by system basis, the effect is to encourage competition and remove barriers to competition by reducing the amount of the charge to be recovered.

STRANDED COST MITIGATION FACTORS

Q: What factors does AEPCO believe should be considered for mitigation of stranded costs?

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A: Obviously, mitigation opportunities and activities will vary on a utility by utility basis so it is difficult to state general guidelines. However, the Commission should take into consideration in AEPCO and other cooperatives' cases the fact that rural areas probably provide fewer mitigation opportunities. Also, because cooperatives have no stockholder class, no "venture capital" exists to fund mitigation activities. Finally, AEPCO believes firmly that mitigation offsets to stranded costs should be attributable only to traditional utility activities.

ELECTRIC COMPETITION RULES PROPOSED AMENDMENTS

Q: Does AEPCO believe there should be amendments to the existing electric competition rules?

A: Yes. In order to clarify mitigation duties and allowable profits and expenses, we recommend the following new language be substituted for the current R14-2-1607.A:

A. The Affected Utilities shall undertake reasonable, cost effective measures to mitigate or offset Stranded Cost. However, neither revenues from nor expenses incurred in non-jurisdictional activities shall be considered in mitigation or calculation of Stranded Cost.

In order to allow stranded cost recovery from all customers, not just those competitively served, on a system by system basis, we recommend that all text after "from customers" be

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deleted in R14-2-1607.H and R14-2-1607.J be deleted in its entirety. Finally, to avoid relitigation of prior Commission decisions in Stranded Cost proceedings, we recommend the following sentence be added to R14-2-1607.I:

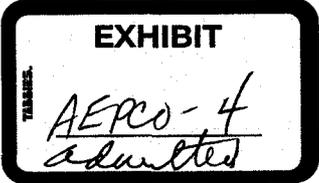
The prudence of an Affected Utility's investment prior to the effective date of this Article shall not be at issue in the Stranded Cost determination.

After reviewing the other parties' testimony in this proceeding, AEPCO may have other recommendations or comments.

Q: Does this conclude your direct testimony?

A: Yes, it does.

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BEFORE THE ARIZONA CORPORATION COMMISSION

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

IN THE MATTER OF THE COMPETITION) DOCKET NO. RE-00000F-94-0165
IN THE PROVISION OF ELECTRIC) (formerly U-0000-94-165)
SERVICES THROUGHOUT THE)
STATE OF ARIZONA)

REBUTTAL TESTIMONY OF

DIRK C. MINSON

ON BEHALF OF

THE ARIZONA ELECTRIC POWER COOPERATIVE, INC.

FEBRUARY 4, 1998

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3 **REBUTTAL TESTIMONY SUMMARY**
4 **OF DIRK C. MINSON**
5 **ON BEHALF OF**
6 **THE ARIZONA ELECTRIC POWER COOPERATIVE, INC. ("AEPCO")**
7 **DOCKET NO. RE-00000F-94-0165**

8 Mr. Minson explains the importance of stranded cost recovery
9 for nonprofit, customer owned cooperatives like AEPCO and why the
10 stockholder/ratepayer debate is irrelevant to cooperatives because
11 their customers are their owners.

12 Particularly in light of AEPCO's negative equity, Mr. Minson
13 also stresses the critical need to recover stranded costs and
14 probable impacts on AEPCO's role in both the regulated and
15 competitive market if recovery is not allowed. Rural areas of the
16 state are high cost service areas and financially viable
17 cooperatives are essential to meet their current and future
18 electricity needs.

19 Mr. Minson also discusses Rules' amendment, calculation
20 methodology, filing timing and rate cap/price freeze matters in his
21 rebuttal testimony.
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2 REBUTTAL TESTIMONY OF

3 DIRK C. MINSON

4 ON BEHALF OF

5 THE ARIZONA ELECTRIC POWER COOPERATIVE, INC. ("AEPCO")

6 DOCKET NO. RE-00000F-94-0165

7 Q: Are you the same Dirk C. Minson who filed testimony in this
8 matter on January 9, 1998?

9 A: Yes, I am.

10 Q: What is the purpose of this rebuttal testimony?

11 A: I will attempt to summarize, at a very high level, AEPCO's
12 position on and reaction to some of the positions taken by
13 other parties in this proceeding. Candidly, the sheer volume
14 of testimony and divergence of opinion on various issues is
15 overwhelming. For this reason, I will not attempt a point-by-
16 point rebuttal of all positions. My silence on any subject
17 should not be construed as any acquiescence by AEPCO on that
18 position or on that issue.

19 SUMMARY

20 Q: Please summarize AEPCO's general reaction to the testimony
21 filed in this docket.

22 A: Understandably, much of the testimony focuses on the conflict
23 which exists in an investor-owned utility environment between
24 the stockholder and the customer. Because of this conflict,
25 various parties to this proceeding are suggesting that this
26 Commission not allow full recovery of stranded costs or require
27 sharing of stranded costs between stockholders and customers.
Without commenting on the fairness of such suggestions

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2 generally, this debate simply is irrelevant to non-profit,
3 customer-owned cooperatives like AEPCO.

4 Q: Please explain.

5 A: AEPCO was formed almost 40 years ago by its four original
6 Arizona member distribution cooperatives to assist them in
7 meeting their obligation to serve their owner-customers in
8 their respective service territories. Both AEPCO and its
9 member distribution cooperatives have as their primary goal the
10 supply of reliable electricity to their owner customers at the
11 lowest, reasonable cost with margins adequate to continue this
12 mission and meet mortgage requirements. To the extent revenues
13 exceed costs, these become customer equity and are returned to
14 the customer over time. Non-profit cooperatives like AEPCO
15 have, by definition, no profit motive. There is no distinction
16 between stockholders and customers. To the extent that
17 stranded costs are not allowed by this Commission or are only
18 partially allowed, in AEPCO and its member distribution
19 cooperatives case, this only harms their customers and weakens
20 the ability of organizations which those customers have formed
21 to continue to supply power in the future.

22 **RECOVERY/NEGATIVE EQUITY ISSUES**

23 Q: Is AEPCO particularly vulnerable to disallowed stranded costs?

24 A: Yes. By design, generation and transmission cooperatives like
25 AEPCO have been highly leveraged organizations with little
26 equity in their capital structures. This allows them to reduce
27 costs, but provides little cushion to absorb losses. As both

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2 Mr. Hedberg and Mr. Edwards have pointed out, this is even more
3 true in AEPCO's case because it actually has negative equity.
4 Thus, an inability to recover stranded costs would seriously
5 damage AEPCO and its member distribution cooperatives' ability
6 to continue to supply electricity at the lowest, reasonable
7 cost to many of the rural areas of this state.

8 Q. What has AEPCO's experience been thus far as it relates to its
9 negative equity position?

10 A. Historically, the negative equity has not prevented AEPCO from
11 securing long-term funds for capital expansion or needed
12 working capital. However, there have been numerous
13 circumstances when AEPCO was required to go to extraordinary
14 lengths to assure suppliers and creditors that AEPCO's balance
15 sheet would not impair our ability to perform under a specified
16 contract. More recently, AEPCO is addressing a contract
17 inquiry relating to our negative equity position even though we
18 have consistently performed over the last seven (7) years under
19 the multimillion dollar purchase power contract which expires
20 in 2000. Another recent example of the impact the negative
21 equity is having and will have on the Cooperative pertains to
22 the restructuring work now underway with the Rural Utilities
23 Service ("RUS"). AEPCO has been specifically told by RUS that
24 additional proof of financial capability will be required if
25 AEPCO wants to change from our current conventional mortgage to
26 a more flexible, less administratively burdensome indenture.
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Q. Specifically, how might AEPCO's inability to recover stranded costs impair the Cooperative's future?

A. First, let me briefly state that AEPCO has made substantial progress over the past several years in addressing its cost structure and its negative equity position. These efforts have resulted in reducing our negative equity position from \$50 million to an anticipated \$22 million at the end of 1997. However, if the Commission issues a Rule or order that prevents the recovery of stranded cost, the Cooperative will be required to record significant write-downs. This would reverse the progress made thus far and significantly increase our negative equity position. As the negative equity balance increases, coupled with an increased risk profile associated with a competitive market, at a minimum the cost of long-term funds will also increase. This, in turn, will obviously increase the cost of service resulting in an upward cost spiral and will harm the Cooperative's ability to serve and compete. I would also remind the Commission that under its Rules for the foreseeable future the obligation to serve does not cease. Therefore, it is critical that stranded costs be allowed to assure viable nonprofit, customer-owned organizations which can continue to meet the needs of serving many of the highest cost areas of this state at the lowest, reasonable cost.

RULES AMENDMENTS ISSUES

Q: In Attachment 1 to Dr. Rose's testimony on behalf of Staff, Staff now suggests that R14-2-1607 be modified to change

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2 mandatory recovery of unmitigated stranded costs to permissive
3 recovery. Does AEPCO agree?

4 A: Absolutely not. Staff's sudden and inexplicable reversal of
5 position both as to the Rules it recommended the Commission
6 adopt as well as positions it articulated in the Working
7 Group's Final Report will complicate, not accelerate, this
8 Commission's stated goal of moving toward competition in the
9 electric industry. Also, if the Commission were to modify its
10 Rules as suggested by Staff, the accounting and financial
11 consequences could be significant. Although I am not an
12 accountant, I work with AEPCO's auditors on its financial
13 statements. I can confidently predict that a statement by this
14 Commission such as the one recommended by Staff that
15 unmitigated stranded costs can be disallowed will have serious
16 and immediate FASB 71 and FASB 121 implications.

17 Q: Mr. Higgins has criticized your suggestion that Section 1607.J
18 of the Rules be deleted. Please respond.

19 A: In my direct testimony (pages 9-10) I recommended Rules'
20 amendments which, among other things, would expedite and make
21 more manageable stranded costs proceedings. For example, I
22 recommended that the prudence of prior investments already
23 decided not be relitigated in stranded costs proceedings and
24 also suggested that stranded costs should be recovered from all
25 customers. I do not necessarily disagree with Mr. Higgins'
26 statement that demand reductions attributable to self-
27 generation options have been available to customers for many

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2 years. Pragmatically, however, sorting out these matters in
3 the context of a stranded costs proceeding will lead to endless
4 debates over whether the self-generation option really exists,
5 whether the option could be exercised in the future and whether
6 load loss is attributable to competition or these or other
7 factors. If this Commission wishes to proceed expeditiously to
8 a competitive market, I would suggest that such debates be held
9 to an absolute minimum. That is one of the primary reasons for
10 the Rules' amendments AEPCO has suggested.

11 CALCULATION METHODOLOGY

12 Q: Several parties have suggested different approaches for
13 calculation of stranded costs. Please summarize AEPCO's
14 reaction to these suggestions.

15 A: In its case, AEPCO believes the "revenues lost" methodology is
16 most appropriate to determine and calculate stranded costs
17 because, coupled with a true-up mechanism, it will accurately
18 measure AEPCO's stranded costs and insure that its customer
19 owners do not pay more or less than is necessary to meet
20 AEPCO's costs and its mortgage coverage requirements. Both
21 Mr. Hedberg and Mr. Edwards have provided additional detail on
22 this subject on AEPCO's behalf.

23 Q: Mr. Propper of RMI suggests that AEPCO plans to divest itself
24 of generation and transmission assets. Is this accurate?

25 A: No. For approximately a year, AEPCO and its member distribu-
26 tion cooperatives have been studying a reorganization plan
27 which may accomplish a number of objectives including, but not

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2 limited to, better positioning of AEPCO and its member
3 distribution cooperatives for a competitive market and allowing
4 member distribution cooperatives who wish to have more options
5 greater flexibility as to an all requirements or partial
6 requirements relationship in the future. This restructuring
7 does not involve the divestiture to a third party of any AEPCO
8 generation or transmission assets.

9
10 **TIMING OF STRANDED COST FILING**

11 Q: Some parties have argued for very early filings of stranded
12 cost estimates. Please respond.

13 A: AEPCO has no intention of delaying unnecessarily the filing of
14 any estimate of its stranded costs. However, AEPCO also wants
15 to be as precise as possible in this stranded costs filing and
16 realistically it cannot do that until the Rules are clarified.
17 Therefore, suggestions that the filing be made as early as
18 April or May of this year are simply unrealistic. Assuming the
19 revenues lost methodology may be employed, AEPCO believes it
20 can prepare and file with the Commission an estimate of
21 stranded costs within 90 days following clarification of the
22 Commission's Rules.

23 **RATE CAPS/PRICE FREEZES**

24 Q: Some parties have suggested that this Commission should impose
25 rate caps or price freezes. Does AEPCO agree?

26 A: No. The terms "rate cap" and "price freeze" are being used
27 rather loosely. I am not certain that I fully understand what
any party means when it uses either term. However, to the

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extent these parties invite the Commission to impose currently a cap or freeze on rate levels without reference to the cost of providing service and other financial requirements, I doubt that concept is lawful. As importantly, to the extent such a cap or freeze is intended to immunize consumers from the consequences of the market, this would be bad policy. Shifting to competition and market based rates entails risks and rewards. Arbitrary regulatory interference to shield customers from the consequences of choice is irrational and does not allow the market to work as it should. Finally, like most price or cost control schemes, in my opinion rate caps or price freezes would be administratively difficult if not impossible to police and undoubtedly would create unintended consequences and gaming possibilities.

Q: Does this conclude your rebuttal testimony?

A: Yes, it does.

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