



Transcript Exhibit(s)

Docket #(s): RE-00000C-94-0165

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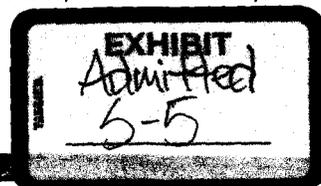
**AN ECONOMIC AND LEGAL PERSPECTIVE ON
ELECTRIC UTILITY TRANSITION COSTS**

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The Regulatory Compact

An examination of the origins and content of the regulatory compact finds little basis for the claim that utilities are always entitled to cost recovery and a return on their investments. Indeed, a strong argument could be made that to be consistent with past

treatment and the manner in which the compact has been interpreted by many states, *full* recovery of transition costs would be inconsistent. There is no "entitlement" to "stranded" cost expressed or implied by the regulatory compact. The only entitlement granted was the revocable privilege to serve an exclusive territory. The obligation to serve stems from this privilege. The compact is not an agreement to pay all costs (prudent or otherwise) because of the obligation to serve. It is much more complex than simply "I am obligated to serve, therefore customers are obligated to pay all my costs." There is no reciprocal obligation on customers to buy, unless there is a written contract.

A description of this regulatory agreement or bargain as historically interpreted, may be as follows: the careful balance between compensatory rates and confiscation of utility property that allows a utility an opportunity to earn a reasonable return on investment in exchange for providing safe and reliable power at reasonable cost to all customers who request service. This is checked by the "used-and-useful" and "prudent-investment" tests, as well as from competition from government ownership, fuel substitutes, and self-generation. The regulatory compact was, by design, intended to protect ratepayers from monopoly abuse, not protect the utility from competition forever.

The debate on transition costs thus far implies that the commission or legislature imposes costs on the utility when it moves to open or direct access, or that regulators or customers *cause* costs. This has shifted the focus away from the origin or controller of these costs, the utility. In an economic sense, retail access and competition do not impose costs — rather they *expose* costs that are uneconomic relative to alternative suppliers. In many respects, it is the tariff or rate that is "stranded," not the investment. An important function of competitive markets is to screen out costs and suppliers that have above-market prices. These may include costs that would have remained hidden if the utility's monopoly was allowed to continue. It is important to remember that the regulatory compact was created originally to protect ratepayer interests, not primarily utility interests.

BEFORE THE ARIZONA CORPORATION COMMISSION

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

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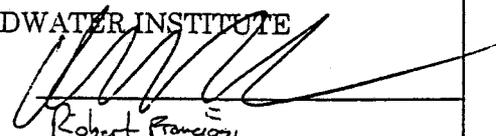
IN THE MATTER OF THE COMPETITION IN) DOCKET NO: U-0000-94-165
THE PROVISION OF ELECTRIC SERVICES)
THROUGHOUT THE STATE OF ARIZONA) NOTICE OF FILING
)

Pursuant to the Commission's Procedural Orders, the Goldwater Institute hereby files the joint testimony of Michael K. Block, Robert Franciosi, and Melinda L. Ogle, in the above captioned matter.

RESPECTFULLY SUBMITTED this 21st day of January, 1998.

THE GOLDWATER INSTITUTE

By:



Robert Franciosi
Goldwater Institute
201 N. Central Avenue
Phoenix, AZ 85004

Original and ten copies of the foregoing
filed this 21st day of January, 1998, with:

Docket Control
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, Arizona 85007

EXHIBIT
Admitted
GWI-1

1 DIRECT TESTIMONY

2 OF

3
4 MICHAEL K. BLOCK,
5 ROBERT FRANCIOSI AND
6 MELINDA L. OGLE

7
8
9
10 INTRODUCTON

11 Q. Please state your names.

12 A. Michael K. Block, Robert Franciosi, and Melinda Ogle.

13
14 Q. In what capacity are you appearing in this evidentiary proceeding?

15 A: We represent the Goldwater Institute a non-profit, non-partisan public policy think
16 tank located in Phoenix, Arizona. We have authored several publications on
17 electricity deregulation: *Hotwiring Deregulation*, *They Layman's Guide to*
18 *Deregulation*, *The ABCs of Stranded Costs*, and *How I Stopped Worrying and*
19 *Learned to Love Dergulation*

20 STRANDED COST ISSUES

21
22 Q: Should the Electric Competition Rules be modified regarding stranded
23 costs, if so, how?

24 A. The rule passed by the ACC defines stranded costs as the verifiable net
25 difference between the value of all of a utility's prudent assets and obligations
26 necessary to furnish electricity, and the market value of those assets and obligations
27 directly attributable to the introduction of competition. The rule allows for the
28 recovery of stranded costs, but does not justify why. Since the rule is now open to

1 change, it is worthwhile to review the pros and cons of why stranded costs should be
2 recovered.

3
4 One of the best, and the most succinct, cases for stranded cost recovery is
5 made in the *Economic Report of the President 1996*.

6
7 *Unregulated firms bear the risk of stranded costs but are entitled to high*
8 *profits if things go unexpectedly well. In contrast, utilities have been limited to*
9 *regulated rates, intended to yield no more than a fair return on their investments. If*
10 *competition were unexpectedly allowed, utilities would be exposed to low returns*
11 *without having had the chance to reap the full expected returns in good times, thus*
12 *denying them the return promised to induce the initial investment.*

13 If regulators arbitrarily renege on the promised return to utility investors,
14 investors will shy away from putting their money into industries dependent on
15 government promises—and the government hasn't been shy about handing out
16 promises. Affected industries could include agriculture, banking, insurance, energy
17 and transportation—not to mention transmission and distribution of electricity
18 which, as currently contemplated, will continue to be regulated. In the future, this
19 could lead to higher costs of capital. Higher investment costs mean that future
20 customers will pay higher prices as a result of the opportunism of the current
21 generation.

22 According to advocates for stranded cost recovery, there is not just a promise
23 but a full regulatory compact between regulators and utilities. Under the regulatory
24 compact, the Corporation Commission sets prices so that utility investors earn a
25 "fair" return on their investment, and keeps competitors out of the utility's service
26 territory. In return utilities must make sufficient investments in generation and
27 transmission to provide service to all customers in its territory. Utilities must also
28 get ACC approval for investments, limit other business activities and support a
variety of programs for energy conservation and renewable energy sources.

1 Champions of stranded cost recovery contend that Arizona courts have
2 expressly recognized the regulatory compact. In *Application of Trico Electric*
3 *Cooperative, Inc.* the Arizona Supreme Court stated:

4 *By issuance of a certificate of convenience and necessity to a public service*
5 *corporation the State in effect contracts that if the certificate holder will make*
6 *adequate investment and render competent and adequate service, he may have the*
7 *privilege of a monopoly as against any other private utility.*

8 Finally, proponents argue that the failure to recover stranded costs could lead
9 to economic inefficiencies. Suppose there are two electric generating companies, each
10 with identical generating plants and costs. One is the incumbent utility, the other is
11 a potential entrant. If the incumbent utility is still burdened with the costs of
12 previous regulations and responsibilities, such as being the provider of last resort, its
13 costs could be higher. This would give its competitor an advantage, even though by
14 the criterion of economic efficiency there is no difference between the two.

15 There is, however, another view. The regulatory compact is an idealistic view
16 of regulation where regulators are diligent guardians of the public interest. The
17 regulatory compact is a polite exercise in pie dividing: utility executives get
18 economies of scale with exclusive franchises; investors get a guaranteed but limited
19 return; interest groups get their subsidies; and consumers get low prices.

20 Nevertheless, as commentators point out, the regulatory compact theory is
21 based on the naïve assumption that none of the parties involved behave strategically
22 (a euphemism that roughly means "taking advantage of the system"); and that
23 regulation is a reliable, smoothly functioning mechanism that ensures all parties
24 benefit from the compact.

25 But as economist Oliver Williamson questions:

26 *What if the managers and workers in regulated natural monopolies*
27 *acquire deep knowledge about the industry and have more and better*
28 *information than both the regulatory agencies and, especially, their*
customers? What if they can and do disclose this information in a
selective way, thereby promoting their (sometimes strategic) purposes

1 *and covering up possible cost excesses and/or investment mistakes? . . .*
2 *. And what if regulators, like many others, prefer an easy life?*

3
4 In other words, there is ample opportunity for utilities to manipulate the
5 system to their advantage, regardless of what the objectives of the regulatory
6 compact are supposed to be. And if utilities have gained from the process all along
7 and obtained extraordinary profits, the case for stranded cost recovery is very weak.

8 There is evidence that shows these are not idle academic musings. A study in
9 the Summer 1991 issue of *Business Strategy Review* found that American utilities
10 were among the most successful companies in the world. The authors of the study
11 looked at something they called added value—a concept closely related to what
12 economists would call economic profit. They found that five of the top ten largest,
13 most successful companies in the U.S. were utilities, as were nineteen of the top fifty.
14 The only companies that do better are pharmaceuticals, who have legal monopolies in
15 patented drugs. If utilities had the chance to earn profits that rival those of
16 unregulated firms, it makes little sense to protect them from losses like those faced
17 by unregulated firms.

18 Although Arizona utilities did not make the list, it's not because Arizona
19 regulators were especially hard-nosed. Investment companies rate the regulatory
20 attitude of state public utility commissions from the investors' viewpoint. A
21 composite of the rankings constructed by economist Peter Navarro during the time
22 covered by the *Business Strategy Review* study ranked the Arizona as having a "very
23 favorable" regulatory climate from a utility investor's point of view; a ranking it
24 shared with eight other states.

25 There is evidence, using more conventional measures, showing utilities have
26 been below average performers over the past few decades. However even if a
27 regulatory compact limited utility investor returns, full recovery of stranded costs
28 would still overcompensate investors for lost opportunities. Companies in every
industry suffer from the occasional investment blunder. Monopolists are especially
susceptible because they do not face the discipline of competition. This monopoly
sloth is given a name that sounds as if it came from some economics B-movie: X-
inefficiency.

1 Full recovery of stranded costs pays not only for costs allegedly imposed by
2 regulators, but for X-inefficiencies as well. Thus, full recovery makes electricity
3 consumers pay for what in other industries would be eaten by shareholders. It also
4 creates bad investment incentives since it allows utilities to play "heads I win, tails
5 you lose" with ratepayers.

6 The case for stranded cost recovery is primarily based on the existence of a
7 regulatory compact. The widows and orphans who invested in utility stock gave up
8 the chance to earn big profits and accepted the burden of various energy and social
9 policies. In return they were protected from the risk of being hit with big losses.

10 How much investors in Arizona utilities actually sacrificed is a factual issue.
11 Another factual issue is how much of so-called stranded costs are due to burdens
12 imposed by regulators, and how much is simply due to monopoly inefficiency. And so,
13 according to some, the right to recover stranded costs should also be a factual issue.
14 However, resolving this question using the hearing process would be too time
15 consuming and, if we use prior experience as a guide, not very accurate.

16 The benefits, if any, that consumers received under any regulatory compact
17 are now outweighed by the costs: sluggish innovation, inefficient investment and
18 prices. The Commission should work to terminate this compact quickly. Although
19 stranded costs are a formidable problem, they should not stand in the way of a rapid
20 move to a competitive market. Utilities are collecting stranded costs now as you read
21 this sentence, through the regulated rates consumers are paying. Delay only means
22 consumers continue to pay stranded costs without the benefits of choice for a good
23 while longer.

24 We suggest a measurement method for stranded costs below that, while not
25 a perfect way of separating out the equity issues, is potentially an expeditious and
26 reasonably accurate method of dealing with stranded costs. In terms of modifying
27 the Rules, we suggest that the Rules explicitly include a provision that stranded costs
28 be measured using a market mechanism (see below) and that recovery be limited to
less than 100% of measured stranded. The exact percentage should be set by the
Commission and included in the Rule.

Q: What costs should be included as part of "stranded costs" and who, if

1 anyone, should be excluded from paying for stranded costs?
2

3 A. With billions of dollars at stake, every aspect of recovering stranded costs is a
4 bone of contention between utilities who want to recover them and customers who
5 would have to pay them. One hotly contested topic is how to calculate stranded costs
6 in the first place. There are two main approaches to doing this: *administrative* and
7 *market based*.

8 Two different administrative approaches are the *net revenues lost* and
9 *replacement cost valuation* methods. The net revenues lost method calculates
10 stranded costs as the difference between the revenue utilities receive under
11 competition and the revenue they would have received if regulation were to continue.
12 The second method, replacement cost valuation, calculates stranded costs as the
13 difference between the value of an asset as it appears in a utility's account books and
14 the most cost effective replacement available.

15 These ways of calculating stranded costs are called "administrative" because
16 they rely on extensive number crunching by the Corporation Commission staff. For
17 the revenues lost method, ACC staff has to estimate future costs for utilities and
18 their revenues under competition. The replacement cost valuation method requires
19 ACC staff to become acquainted with the intricacies of power plant construction.

20 Problems with the administrative approaches are numerous. Competition
21 does more than lower prices, it also lowers costs. So, the extent to which utilities can
22 reduce, or mitigate, stranded costs would also be a source of dispute. And since no-
23 one can predict the future perfectly, errors in these processes are inevitable. Periodic
24 true-ups can be held to replace the old errors with new ones.

25 Nevertheless, administrative approaches have a high comfort level among the
26 members of the regulatory complex, and so are the most commonly advocated ways of
27 calculating stranded costs.

28 The administrative approaches rely on the same bureaucratic tealeaf reading
that got us into the stranded cost mess in the first place. Instead of having ACC and
utility soothsayers argue over how many assets will be stranded in a competitive
market, it would be better to have the market itself tell us.

1
2 Recovery of stranded costs is supposed to compensate utility owners, whose
3 returns were previously capped, for losses in the value of their investment caused by
4 competition. A simple method of compensation would be to pay investors the
5 difference between the book value of the company before deregulation and the value
6 of their stock holdings after. The problem with this is that the stock price will
include speculation on how much stranded cost would be recovered.

7
8 To get around this problem, a utility's stock could be split in two. Every
9 investor would receive one share of A stock and one share of B stock for every
10 original share she owns at the time of the split. The A shares give the investor the
11 usual rights and benefits of a shareholder. The B shares give their holders sole claim
12 against any stranded costs recovered by that company. That is, *all recovered
stranded costs attributable to a company will be paid solely to holders of that
company's B shares.*

13
14 This approach is quick, simple and fair. It has also been used before by
15 Golden State Bancorp, the holding company of a California thrift. In this case,
16 Golden State stock was being run up due to speculation about the value of a pending
17 legal award. To separate the effects of this speculation on share value, Golden State
18 split their stock: one share representing the usual ownership rights, other entitling
the holder to 85 percent of value of the pending legal award.

19
20 **Q: How and who should pay for "stranded costs" and who, if anyone,
21 should be excluded from paying for stranded costs?**

22
23 **A:** Recovering stranded costs means taking money from electricity consumers
24 through some sort of charge and giving it to utilities or, in the case of the stock split
25 plan described above, directly to utility shareholders. The stranded recovery fees,
26 also called competitive transition charges (CTCs), are usually proposed as being non-
27 bypassable, that is customers would pay them regardless of where they bought
28 power. Customers could have the option of paying all the stranded recovery fees they
owe up-front in a lump sum (called a manumission fee in the olden days.)

1 In some states, utilities have the option of collecting all the stranded costs
2 owed to them at once. The money is raised through the sale of bonds backed by
3 future stranded fees collected from customers. This is called securitization.

4 The basic objective in designing a way to recover stranded costs should be to
5 avoid visiting the sins of the past on the future. Whatever the cause of stranded
6 costs, their recovery should not distort the future energy consumption decisions of
7 residential and business users.

8 In order to keep stranded cost recovery as harmless as possible, it should be
9 collected using a fixed, non-bypassable monthly charge that does not vary with the
10 amount of electricity used. Such a charge would have minimal impact on electricity
11 consumption. In this way, it is better than the most commonly proposed way to
12 recover stranded costs: a fee imposed on every unit of electricity consumed, usually
13 referred to as a kilowatt-hour (kWh) fee, or wires charge.

14 The fixed charge should also not vary by geographic region or company.
15 There is no reason why residential or business location decisions should be based on
16 the differences in past performance of the utilities that formerly served the region
17 under regulation.

18 The superiority of a fixed charge is best shown with an example. A typical
19 household in former APS territory would have to pay about \$103 per year for five
20 years to pay for every \$1 billion of APS stranded costs. Paid as a monthly charge on
21 the bill, it would represent a modest 0.33% decrease in their income. A consumer
22 could spread this decrease over all her purchases, causing a minimal impact on her
23 living standard.

24 However, if stranded costs were recovered through a charge per kilowatt-
25 hour, the same household would pay 14 percent more per unit of power used. Since a
26 higher price means you buy less, a kilowatt-hour charge forces consumers pay for
27 stranded costs by buying significantly less electricity, instead of giving them a choice
28 in how to change their buying decisions. With a kilowatt-hour charge, consumers to
pay for stranded costs with a lot of sweat during the summer rather than a tiny
decrease in how much they spend on renting videos. Forcing all of the recovery

1 charges onto electricity consumption can cause a significant change in the standard
2 of living for the poor and the elderly.

3
4 The most common reason used to support a kilowatt-hour charge over a fixed
5 charge is fairness: with a kilowatt-hour charge, big users would pay more than small
6 ones. However, a fixed charge can be adjusted in a variety of ways to make it less
7 burdensome on small consumers. For example the size of the fixed charge could be

8 linked to *past*
9 consumption. (The
10 important thing is
11 that a stranded cost
12 charge not raise the
13 price of current and
14 future kilowatt-
15 hours a consumer
16 uses.) The nearby
17 table shows how
18 fixed stranded recovery fees can be adjusted by past consumption.

Past Monthly Usage (kWh/month)	Monthly Stranded Recovery Charge
0-400	\$1.92
401-850	\$6.02
851-1300	\$10.35
1301-1800	\$14.92
1801-2600	\$21.17
Over 2600	\$25.02

STOCK MARKET VALUATION PLAN

STAGE 1:

BOOK VALUE	12/31/98	\$5b
ADJ. STOCK VALUE	3/1/99 - 3/3/99	4b

STRANDED COSTS: \$1b

B STOCK COUPON
\$1b

STAGE 2:

STRANDED COST RECOVERY FUND EST.
(ACC FUND) TO COLLECT: \$200MM/year (for 5 years)

STAGE 3:

SPECIAL BILLING Generated by Affected Utilities

Customer Name	1996 Useage	Annual/Monthly Stranded
John Doe	10,200 kWh/yr 850 kWh/mo	\$72.24/year 6.03/mo

STAGE 4:

CUSTOMERS CHOOSE - SUPPLIERS BILL/ REMIT ST. COST \$ TO FUND

<u>Company/ Customer</u>	<u>Current Useage</u>	<u>Future Useage</u>	<u>Useage Bill Amount</u>	<u>Stranded Cost Charge</u>	<u>Bill Total</u>
A. John Doe	850 kWh	850 kWh	\$100.00	\$6.02	\$106.02
B. Jane Doe	850 kWh	1000 kWh	95.00	6.02	101.02
C. Jack Doe	850 kWh	1200 kWh	92.00	6.02	98.02
TOTAL ANNUAL COLLECTED				\$200MM (paid to S.C.R.F.)	

EXHIBIT
Admitted
AG-3

A/B STOCK METHOD

	<u>FORMULA</u>	<u>VALUES</u>	<u>DIFFERENCE</u>
	BOOK VALUE	\$ 23.88	
Less	<u>VALUE OF A</u>	<u>- 40.12</u>	+ 69%
Equals	B (Stranded)	- 16.24	- 40%

