

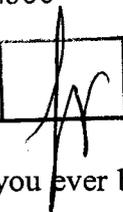
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Arizona Corporation Commission
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Commissioner Jim Irvin

Arizona Corporation Commission
Dissenting Opinion
Decision No. 61973
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AZ CORP COMMISSION
DOCUMENT CONTROL

Have you ever been promised a present, given a different one, and then asked to pay for it yourself? Well, that's what has happened to Arizona residential consumers and small businesses with the Commission's approval of the Arizona Public Service ("APS") settlement agreement/contract. In sum, Arizona consumers were promised robust competition, given a modest rate cut (actually, 6.83%), and then asked to pay for that rate cut to the tune of an additional *minimum* of \$350 million dollars in stranded cost recovery for APS (plus an undetermined amount for "transition" costs associated with creating affiliates to handle competitive ventures). The parties to this settlement agreement are APS, AECC (a representative of industrial and commercial interests), the Residential Utility Consumer Office¹ (RUCO – a state utility "watchdog") and Arizona Community Action Association. Excluded from participating in the negotiations was the Arizona Corporation Commission, the Arizona Consumers Council and potential competitors of APS, like PG& E Energy Services, Commonwealth Energy and others. Such exclusions – as well as a lack of adequate representation for residential consumers – testify to the fact that this settlement agreement does not encompass the wide spectrum of interests it holds itself out to represent.

¹ In the recent Auditor General's performance audit of RUCO, it states, "According to the act establishing RUCO, the agency is intended to represent the interests of residential consumers, critically analyze proposals made by public service corporations to the Commission, and formulate and present recommendations to the Commission." According to Greg Patterson – then Director – RUCO did not perform any type of critical analysis to determine whether the benefits to residential consumers are fair and

Consumers Promised Competition

When the Commission embarked on deregulation over five years ago, the primary purpose was to restructure the electric industry by introducing the generation portion of utility service to the wonders of the free marketplace – where robust competition would spark innovative technologies, and consumer choice would improve quality of service and drive rates downward. Incumbent monopolies such as APS fought hard and challenged the Commission's authority to change the regulatory paradigm, but so far these legal challenges have been unsuccessful.

On September 21, 1999 – as I promised voters in 1996 to help bring about competition in Arizona – I voted for a second time in favor of the Electric Competition Rules (“Rules”) for the purpose of beginning the deregulation process; one that had been stalled earlier this year. While the Rules are not perfect, and while future Commissions will need to make adjustments to the Rules to assure a ‘fair’ competitive market, I believe they provide a framework where consumer and free-market interests enjoy some safeguards. However, only *two days* after these Rules were adopted, the Commission has now approved a settlement which, among other things, gives many “exemptions” and “waivers” from provisions in the Rules which conflict with the APS settlement contract.

When potential competitor after competitor testifies that the APS settlement agreement will not provide an appropriate atmosphere for competition within APS' service territory, it is our role as regulators to at least consider their arguments. Unfortunately, at least one Commissioner indicated he was unwilling to consider any amendment unless it was proposed by a party to the agreement. However, many

reasonable in light of APS' stranded cost recovery figure, or whether the figures supplied by APS and AECC are accurate.

potential competitors – which are not parties to the settlement -- argue that the shopping credits provided for in the settlement are too low, a view supported by Commission Staff.

Staff opined that it had, “demonstrated that the proposed shopping credits were inadequate when considered in reference to each entire class of customers. The fact that one particular customer may experience an adequate shopping credit does not justify the Commission’s approval when the referenced customer’s usage characteristics are different than those of the class as a whole.”² In fact, Staff argued that making a modification to the shopping credit would make it more likely that a competitive market can develop without increasing rate levels, and still allow the company to collect all its stranded costs. Not surprisingly, APS counsel stated during Open Meeting that any increase in the shopping credits would be a “dealbreaker.” My proposed amendment was then subsequently voted down, as was the opportunity to develop a more competitive market in Arizona.

Consumers Given Modest Rate Cuts

One provision of the APS settlement agreement hailed by consumer groups such as RUCO is the modest 6.83% rate cut to residential Standard Offer customers. How RUCO came to this conclusion is unclear; its Director admitted during testimony that no critical financial analysis of *any portion* of the agreement was conducted by its staff. Timothy Hogan, who represents the Arizona Consumers Council (which is opposed to the settlement) asked the appropriate question; “Is it enough?” APS has not been through a full rate case since 1988, and this Commission has not undertaken the

² Staff’s Exceptions to Recommended Order

process to determine if the company has been – or is currently – overearning profits. The population in the Phoenix metropolitan area has exploded since 1988, and one can ascertain that customer growth has mirrored that number as well. If the goal of this Commission was to get rate cuts for all consumers, a rate case certainly would have been less onerous and less expensive to all parties than the monumental effort to deregulate the generation portion of the electric industry.

More disturbing is the fact that these “guaranteed” rate cuts are not guaranteed at all. Of the 7.5% rate cut APS proposed, about one-tenth of that number was already ordered by this Commission in 1996. In addition, the company reserves the right to come back and seek changes to its rates prior to July 1, 2004 (the year the “guarantee” expires) in the event of an unforeseen event or an emergency. APS claims that these rate cuts will save all consumers close to \$475 million dollars in savings during this transition period. However, Commission staff estimates that the savings are closer to \$329 million dollars, with about \$173 million going to residential consumers. Unfortunately, RUCO and ACAA conducted no analysis at all.

Customers Pay through Stranded Costs

“Stranded Cost Recovery” is a term artfully used by incumbent utilities to explain why consumers should have to pay them to change the system. Under the original Stranded Cost Order, incumbent utilities such as APS would have had to divest themselves of generation assets – a process which would give a clear indication to all parties of their value. However, the Rules were changed in April, 1999 to allow incumbent utilities to utilize *any* method outside divestiture to recover its stranded costs. In an article appearing in Forbes earlier this year entitled “Poor me,” Christopher Palmeri

writes, "Not every state legislature or utility commission has the political will to force divestiture, however." After explaining how incumbent utilities often litigate the matter of stranded cost recovery as a tactic of delay, he writes, "For this reason, legislators and regulators sometimes feel like they need to cut some deal, any deal, just to get a competitive market moving forward." It is a tactic that has worked brilliantly for APS.

The argument advanced by APS is that in changing the regulatory paradigm from one of a monopoly system to a competitive marketplace, certain investments (such as generation plants) lose value. If anything, the market has shown throughout many states (CA, MA, NY, CN) that generation assets can be sold at nearly twice the book value of the plant.³ Although APS contends that its generation assets are at least \$533 million dollars over market value, how can the market value be determined when nothing has been offered for sale in Arizona?

The Commission has had a long standing practice (and one which I support) of allowing utilities' shareholders to keep fifty percent (50%) of any net profit of assets divested. The other fifty percent (50%) is returned to ratepayers who paid for those assets. So how does a utility get around this concept of "stranded benefit"? Instead of divesting themselves of the asset through the open market, they transfer it to an affiliate at "book value," thus bypassing any need to account for a net profit. Meanwhile, the asset still retains its higher "market value" and, if then sold by the generation affiliate, may fetch a hefty price. Only with divestiture can the open market determine whether a utility is left with "stranded costs" or "stranded benefits."

³ Palmeri writes, "According to data collected by Cambridge Energy Research Associates, the average nonnuclear power plant put up for sale last year sold for nearly twice its book value." Forbes

Another justification APS advances for the recovery of stranded costs is that "lost revenues" will result by losing current customers to new market entrants. If this is true, why did Pinnacle West Energy Corporation (an APS energy affiliate) announce plans to build and upgrade new generating facilities to meet the demands set by customer growth?⁴ In its recent application to the Commission, Pinnacle West Energy Corporation writes:

"The growth rate in electricity use has exceeded six percent a year for Arizona Public Service Company (APS) customers in Arizona. Growth in the metro-Phoenix area is expected to increase peak customer demand for power from 7,000 MW in 1999 to over 9,000 MW in 2005. In order to meet that need, new generating plants and transmission lines will be needed to import more power into the Valley."

And I thought consumers in Arizona were being asked to pay for "stranded costs" because of lower valued plants, in addition to APS' estimates on how many customers it stands to lose to new market entrants. APS Energy Services (an APS marketing affiliate) already markets power in other states such as California. So, while Arizona consumers are being asked to foot the bill for APS' stranded cost recovery, California consumers are being marketed "competitive" cost power by its affiliate.

Conclusions

1. The APS settlement contract does not promote competition. Rather, it protects the status quo, making Standard Offer Service more attractive to the average consumer and tougher for competitors to effectively compete within APS' service territory. Also, the shopping credits provided for in the agreement are too low.

⁴ In 1988, APS' customer based was 582,003. In 1996, it was 717,614. In 1998, it had grown to 798,697. These figures are based on APS filed annual reports.

2. The aggregate 6.83% rate cut over the next four years is a modest figure considering that APS has not been through a rate case since 1988. Is it enough, given APS' rapid growth in its customer base since that time? And what about the so-called "guarantee," even though APS reserves the right to change its rates in the case of an emergency?
3. Parties to the agreement like RUCO did not perform a critical financial analysis of the proposal, either with regards to the consumer rate cuts or the stranded cost recovery for APS. Furthermore, they accepted the information provided by APS and AECC without analyzing its veracity.
4. APS has not proved it is entitled to its stranded cost recovery figure. Commission staff estimates that under the APS methodology, stranded cost recovery should be approximately \$110 million dollars, far below the estimated figure of \$533 million calculated by APS. Additionally, Arizona's Court of Appeals has ruled that utilities do not have a "regulatory compact" with the Commission, a concept advanced by utilities to justify their reasons for stranded cost recovery.
5. The agreement provides for exemptions to APS to the recently passed Competition Rules; rules which attempt to bring about a level playing field to foster a competitive market in Arizona. Such exemptions render the protections for fair competition in the Rules meaningless.
6. Attempting to bind future Commissions to the "benefits" bargained for by the parties has been challenged as unconstitutional, and -- contrary to APS' assertions made in the settlement agreement -- its adoption by this Commission will create *more* litigation rather than less litigation.

In my opinion, the APS agreement/contract passed today represents an affirmation of the status quo, does not promote competition through a leveled playing field, and contains rate cuts which could likely have been more if obtained through a rate case. Because the provisions contained therein are not in the public interest, I cannot vote in favor of the agreement, and must therefore dissent.



Jim Irvin, Commissioner
Arizona Corporation Commission