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BEFORE THE ARIZONA CORPORATION COMMISSION

BOB STUMP
Chairman
GARY PIERCE
Commissioner
BRENDA BURNS
Commissioner
BOB BURNS
Commissioner
SUSAN BITTER SMITH
Commissioner

Arizona Corporation Commission
DOCKETED
AUG 16 2013
DOCKETED BY

IN THE MATTER OF THE COMMISSION'S INQUIRY INTO RETAIL ELECTRIC COMPETITION.

Docket No. E-00000W-13-0135

SRP'S NOTICE OF FILING RESPONSIVE COMMENTS REGARDING RETAIL ELECTRIC COMPETITION IN ARIZONA

Pursuant to the Commission's letter of May 23, 2013, Salt River Project Agricultural Improvement and Power District provides these responsive comments as an interested party regarding retail electric competition in Arizona.

RESPECTFULLY SUBMITTED this 16th day of August, 2013.

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Responsive Position Paper of the Salt River Project
Docket No. E-00000W-13-0135
August 16, 2013

Executive Summary

The position papers of the proponents leave the major questions unanswered:

- *In a deregulated structure, who is going to plan and build the significant facilities needed to maintain reliable electric service as Arizona grows and prospers?* In a market dominated by short-term motives, the generation needed for long term growth and reliability simply will not be built.

- *What are the fundamentals that will produce price drops?* Deregulation will add significant costs to the system. Yet, no proponent suggests how it is that deregulation will cause electricity to be produced at a lower cost. Some of them admit that deregulation simply shifts costs among customers.

- *How does it benefit Arizona to lose control of its electricity destiny?* Under deregulation the Corporation Commission and the elected bodies of public power entities will have little control over generation or transmission. The control of generation prices will move to the wholesale market, regulated by FERC. The control of transmission will likely move to a regional RTO (also regulated by FERC). If Arizona were to join the California Independent System Operator, as suggested by the Goldwater Institute, our energy policy would likely be dominated by California politics.

- *Exactly what are the innovations that we might expect to see?* There are no specifics to back up the argument that deregulation brings innovation. Arizona electric customers are not asking for deregulation because they are happy with the reasonable prices, many choices and excellent customer service that they now enjoy.

- *Who is going to pay for all of this?* The power marketers are not volunteering to pay the cost of moving to a deregulation market. The cost of restructuring will be hundreds of millions of dollars including the cost of establishing the markets and organizations, the cost of retooling complex systems, the cost of customer education, the cost of policing power marketers, and the cost of the years of litigation that will ensue. The Goldwater Institute recommends at least 23 major initiatives to restructure the industry. AECC recommends at least 39 steps. It is not fair to saddle Arizonans with these costs, for the potential benefit of a few.

The cost and risks to move to deregulation far outweigh any theoretical benefits. SRP respectfully requests that the Corporation Commission close this docket.

SRP expands on these points below. It then analyzes the few proposals that have been set forth by the proponents.

Analysis of the Proponents' Arguments on the Major Issues

Unanswered Question 1: In a deregulated structure, who is going to plan and build the significant facilities needed to maintain reliable electric service as Arizona grows and prospers?

The proponents argue that deregulated markets by themselves will support capacity additions and reserve margins. This argument should concern Arizona more than any other. This argument, made most forcefully by the Goldwater Institute, is simply flawed. Electricity is unique. It is essential for life. We need it all the time. It cannot be stored. There must be a precise real-time match of generation and load at all times. The ability to transport electricity is limited. Real entry into the market is very limited (as new capacity additions take years and cost hundreds of millions of dollars). Electricity needs to be affordable, all the time.

This is hardly a market with characteristics favoring nimble entrepreneurs. Yes, economic theorists will say, correctly, that the markets will *eventually* produce new capacity. But, if that is carried to its logical extreme, this is only after shortages of supply cause prices to dramatically rise to a very high level that might support new investment, made by those with the capacity to withstand the significant risks.

Right now the wholesale markets are driven by short-term marginal costs. This is because a current excess of generation in the market drives wholesale prices toward short term fuel costs. But, economic theory tells us that new plants will not be built until the market rises at least to the level of long term marginal costs (prices that will support a return on investment). And, given the risks, the investment period and the amounts, prices would have to rise to even higher levels to spur investment. Even then, the investment will be quickest to the market with the cheapest fuel source (not necessarily the best choice for long range planning).

This type of market puts at risk important assets to Arizona, such as the Navajo Generating Station (NGS) and the Four Corners Generating Station. The Navajo Generating Station, for example, provides stable and low cost power for Arizona customers and the Central Arizona Project. The future course for NGS is not determined. But, whatever the course, NGS will require significant investment to keep the plant operating, for the *long term benefit* of Arizona.

A deregulated electric market will not support this type of investment. This is because, as mentioned, a market-based structure will favor generation with lower capital costs (even with variable or higher fuel costs) because investors will find it necessary to quickly recover their capital costs in an uncertain environment.

We see this phenomenon playing out in the deregulated markets. While the proponents point to additions they ignore the fact that reserve margins are falling, in some places to

critical levels (in other words, capacity additions to ensure reliability are not keeping pace with growth). They also ignore the crisis situation which is leading to the establishment of capacity markets (capacity supported by the RTO) and the establishment of wholesale price caps that are hundreds of percent higher than average wholesale prices.

Texas provides a prime example of falling reserve margins. In January 2013, the CEO of the North American Electric Reliability Corporation (NERC), Gerry Cauley, sent a letter to the CEO of the Electric Reliability Council of Texas (ERCOT) expressing concern over reliability in Texas stating that "[c]apacity resources in ERCOT have drifted to a level below the Planning Reserve Margin target and are projected to further diminish through the ten-year period covered in the assessment." Mr. Cauley also reminded ERCOT that this was not the first time NERC has raised these concerns with ERCOT.[1]

In response ERCOT admitted that its planning reserve margins could drop well below its 13.75% target within the coming years and that capacity will continue to tighten over time without investment in new generation resources in the region.[2] ERCOT estimates that reserve margins will fall from 13.2% in 2013 to 2.8% in 2022.[3]

More recently, in May 2013, ERCOT stated that, "[w]ith tight operating reserves expected this summer, especially during the late afternoon hours on the hottest days, it is likely that ERCOT will initiate conservation alerts or power watches on some days. These alerts ask the public to reduce electric use to help ERCOT maintain reliability of the grid." ERCOT also noted that increased power demands could lead to implementation of "Energy Emergency Alert" actions with the possibility of rotating outages if needed to protect the grid.[4]

In an attempt to minimize the risk associated with dwindling reserve margins, the Public Utility Commission of Texas voted at the end of October 2012 to increase price caps in the state's wholesale power market. The cap would increase first to $5,000/MWh effective June 1, 2013, then to $7,000/MWh effective June 1, 2014, and finally to $9,000/MWh effective June 1, 2015, to help generators realize more revenue.[5] To put this in perspective,

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[1] NERC, Letter from Gerry Cauley to Trip Doggett, January 7, 2013. Available at http://www.ercot.com/content/news/presentations/2013/NERCletterto TripDoggettonResourceAdequacyJan72013.pdf

[2] Statement of ERCOT CEO Trip Doggett regarding January 7, 2013, letter from NERC CEO Gerry W. Cauley. January 16, 2013. Available at http://www.ercot.com/news/press_releases/show/26390

[3] ERCOT, Report on the Capacity, Demand, and Reserves in the ERCOT Region, Winter Update (December 2012). Available at http://www.ercot.com/content/news/presentations/2012/CapacityDemandandReservesReport_Winter_2012_Final.pdf

[4] ERCOT expects tight summer conditions, long-term outlook shows improvement. May 1, 2013. Available at http://www.ercot.com/news/press_releases/show/26433

[5] Texas electric prices cap to double over 3 years, Chris Tomlinson, Bloomberg BusinessWeek, October 26, 2012, Available at http://www.businessweek.com/ap/2012-10-26/texas-electric-prices-cap-to-double-over-3-years.

the range of wholesale prices during the last year at the Palo Verde hub (Arizona) was between $25 and $130/MWh.[6]

However, according to an analysis conducted by ICF International, ERCOT's system-wide offer cap would have to rise above $15,000/MWh for the market to sustain a 13.75% percent target reserve margin and generate adequate price signals for new entrants. And, even if price caps were to increase that much, the weather-driven risk means that the market may not bear the net cost required for new entrants.[7]

In calling for the establishment of a capacity market in Texas, John Ragan, the president of NRG Energy's Gulf Coast Region (the second-largest generator in Texas) said:

> There is little incentive for investors to build new, billion-dollar power plants because the price of electricity is so low. The low cost of natural gas, among other factors, has driven energy prices down - good for consumers in the short-term, but dangerous to long-term reliability because demand for power is growing faster than new generation is being built.[8]

PJM (as well as MISO) currently has a docket open with FERC as it struggles to resolve capacity deliverability issues.[9] Five years ago, PJM established a capacity market to try to deal with the issue within its borders. But, the market only seeks capacity assurance three years into the future. Much of the capacity offered over the past five years has been demand-side management, and no central station plants have been proposed or built in PJM during this period. While reserve margins are currently adequate there, the heavy reliance on demand side reductions and the lack of any projects adding base load capacity are troubling to many observers of that market.

In other words, as historic excess capacity is used up, we are seeing a phenomenon called *re-regulation*. PJM is farthest along this road. It has established PJM itself as the entity that procures generation based not on the market, but on the strength of non-bypassable *cost of service* charges. As these structures further mature, we will see more and more reliance on cost of service pricing, simply because this is the only mechanism that addresses the issues that are unique to electricity, and necessary for our lives.

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[6] Energy Information Administration, Wholesale Market Data, Wholesale Day Ahead Prices at Palo Verde Trading Hub between July 19, 2012 and July 19, 2013. Data available at http://www.eia.gov/electricity/wholesale/

[7] ICF International, ERCOT Scarcity Pricing: Potential and Risks, February 26, 2013. http://www.icfi.com/insights/webinars/2013/recording-ercot-scarcity-pricing-potential-and-risks

[8] John Ragan, Ragan: Time for Texas to add to state's electric grid, *Houston Chronicle*, June 11, 2013, http://www.chron.com/opinion/outlook/article/Ragan-Time-for-Texas-to-add-to-state-s-electric-4594395.php

[9] FERC Docket No. AD12-16-000; Presentations on this issue were presented to FERC at its June 20, 2013 Open Meeting and are available at http://www.ferc.gov/

But *this is the approach that we already have today in Arizona*, with our vertically integrated utilities. There is no point in going through a tumultuous exercise of industry restructuring, only to end up with a cost of service structure much like we have now.

The bottom line is clear. Left to its own devices the market will produce capacity shortfalls until demand causes prices to dramatically increase. Then, while prices remain very high and capacity shortfalls increase, plants may be built with a lag time of three to five years. Then the cycle will likely repeat itself. There is no long term planning.

This is not a sustainable market for a commodity essential to life, as the deregulated areas are learning. We cannot let this happen in Arizona, even with the promises that are being made to us by the out of state marketers.

Unanswered Question 2: What are the fundamentals that will produce price drops?

The proponents argue that prices will be lower under deregulation, presenting several studies to support their position. The opponents of deregulation have also presented studies supporting their position. But, there is one study that bears close attention, as this is the study that truly compares the difference in pricing *in the same market.* That is the study that compares those areas of Texas that are participating in deregulation, against those areas of Texas that are not participating in deregulation.[10]

The difference between the Texas deregulated areas and the Texas non-deregulated areas is striking. Prices in the deregulated portion during the period from 2002 to 2010 were at times 46% higher than the regulated areas. While prices in the deregulated areas are beginning to drop due to natural gas prices, proponents can hardly argue that the market produced better prices for Texas consumers than the regulated areas.[11]

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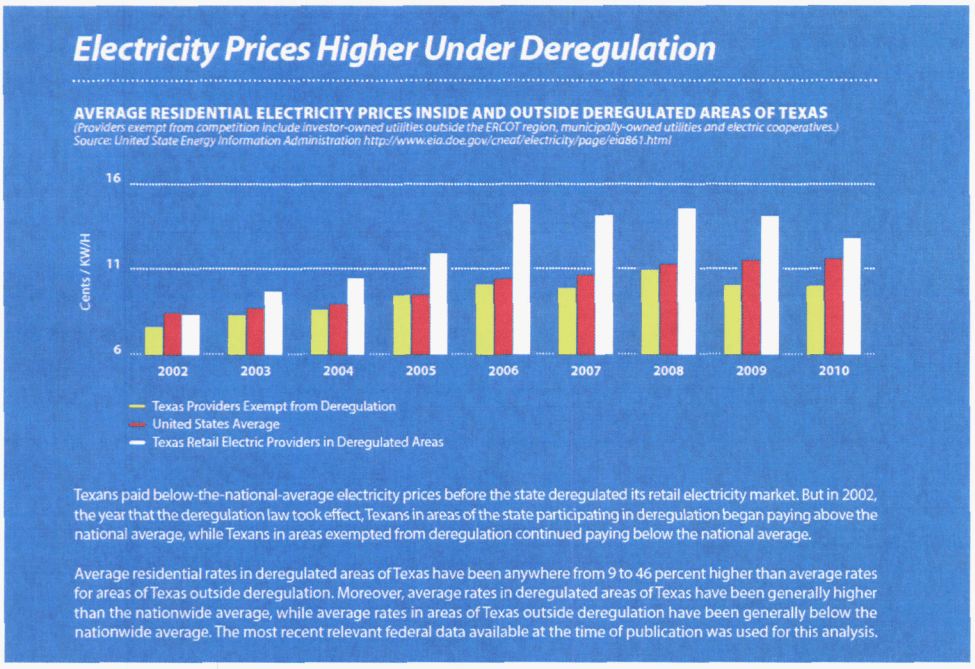
[10] In Texas municipal utilities were given the ability to opt out of deregulation, and they all decided not to participate. These include Austin Energy (City of Austin), CPS Power (the City of San Antonio) and the Lower Colorado River Authority (Central Texas).

[11] Texas Coalition for Affordable Power *Deregulated Electricity in Texas, A History of Retail Competition*, Page 26 (December 2012). Available at http://tcaptx.com/wp-content/uploads/2013/03/SB7-Report-2012.pdf



It is not surprising to see these results. Fundamentally, the costs of generating electricity are fixed. That is why deregulation is called a "zero sum game". In other words, the entrepreneurs in deregulated markets are not figuring out cheaper ways to produce electricity. Then we add to the deregulated market the extra costs inherent in this structure. These include the costs of establishing and maintaining organizations and markets, the price difference between cost of service pricing and profit maximizing pricing, and the cost of deterioration from an effective generation mix. The results of this comparison are easy to understand.

The Retail Competition Advocates[12] claim that the idea that deregulation is a *zero sum game* is a *myth*.[13] Yet, neither the Retail Competition Advocates nor any of the proponents present a single study or comment that refutes this logical premise in any analytic way.[14] Instead the comments look at "studies" of prices in deregulated markets. But, even the few studies that show favorable outcomes do not address *where and how* these savings are generated. They do not refute the premise that price drops are caused by low natural gas prices, wholesale market swings, or the fact that prices in these states were high to begin with.

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[12] We will refer to the paper filed by the "Retail Competition Advocates" (consisting of Direct Energy, Constellation and Noble Americas) and the "Retail Electric Supply Association" as the "Retail Competition Advocates or "RCA" position

[13] RCA July 15, 2013 position paper, page 19.

[14] The only arguable difference would be that demand response is increased in deregulated markets. Arizona already has significant demand response programs. And, demand response has its limits, it is not steel in the ground.

For example, the Retail Competition Advocates claim that between the years 1997 to 2012 retail prices in deregulated states have decreased by 4% while prices in regulated states have increased by 7%, attributing these numbers to the effects of deregulation.[15] But, these numbers paint an inaccurate picture.

First, states that chose to restructure their retail markets represented the highest-priced states. A primary impetus for restructuring was to lower such high prices. Therefore, when looking at price changes in *percentage terms only*, the restructured states will falsely appear to have lower price increases. For example, Colorado, a non-deregulated state, had an average residential retail electric price of almost 7.42 cents per kWh in 1997, which increased by 3.93 cents to 11.35 cents in 2012, a 53% increase. Massachusetts, a deregulated state, saw prices rise from 11.59 to 14.96 cents in this same time frame, a 3.37 cent or 29% increase. Colorado consumers are clearly better off, with average bills (11.35 cents) below what Massachusetts consumers paid at the start of restructuring (11.59 cents), despite the higher percentage increase (53% v. 29%) and larger actual increase (3.93 cents v. 3.37 cents).[16]

The fact is that those states that restructured their retail markets and are located within RTOs had an average electricity rate of 12.6 cents per kWh in 2011, 3.7 cents or 42% *greater* than states that remained regulated. At the start of retail and wholesale restructuring in 1997, the difference was actually *lower* between the two groups, equal to 3.1 cents.[17] Given that restructuring was initiated to lower these rates, the fact that the gap widened shows a negative impact on consumers.

Second, the proponents' claims also fail to take into account the increased reliance on natural gas as a fuel in the deregulated markets. Between 2008 and 2011, average natural gas prices nationally declined by almost 50%. Over this same time frame, natural gas as a percentage of Pennsylvania's generation mix increased from about 8% to over 18%.[18] This is the period in which the data for Pennsylvania's average retail rates begin to show a small decline. But in fact, with the significantly greater use of gas and the significant reduction in gas costs, one should have expected an even greater reduction in retail rates after 2011 in Pennsylvania. Most certainly, the decline in average retail prices in Pennsylvania relative to the national average can be explained by the increased reliance in natural gas at a cheaper price within PJM, and not as a result of restructuring which had occurred more than a decade earlier.

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[15] RCA July 15, 2013 position paper, page 6.

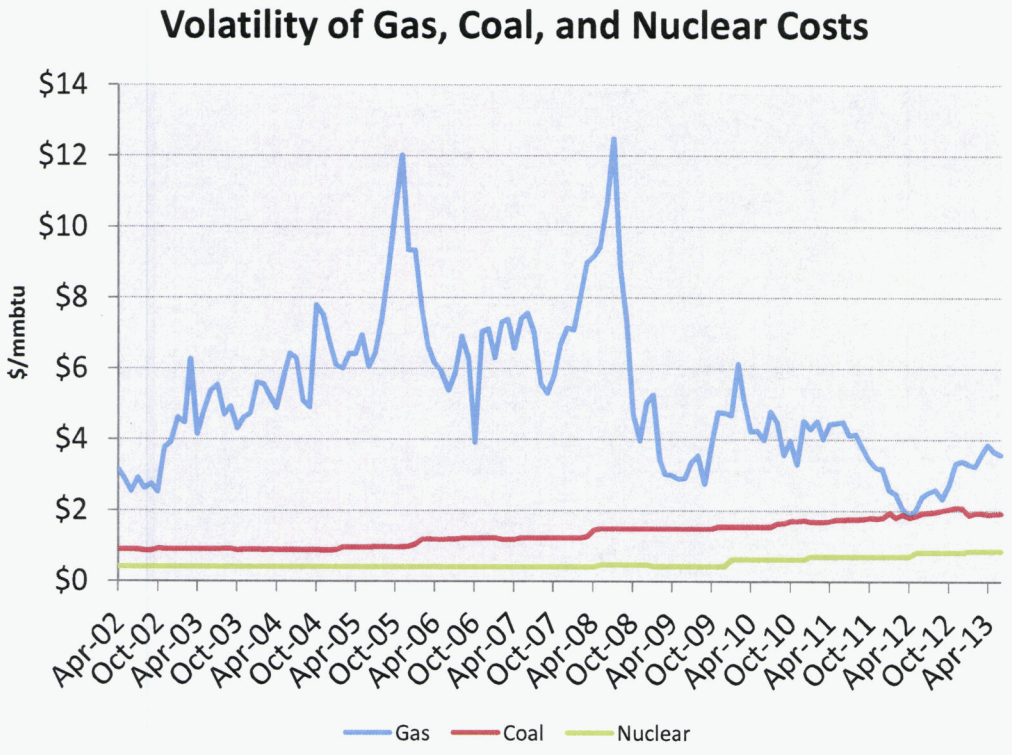
[16] Energy Information Administration, Average Price of Electricity to Ultimate Customers, Electricity Data Browser; Energy Information Administration, Electric Sales and Revenue, Table 12, Average Revenue per Kilowatthour by Sector, Census Division, and State, 1997.

[17] Monitoring Analytics, Inc. "PJM State of the Market – 2012", March 14, 2013, Volume 2, p. 54..

[18] Energy Information Administration, Net Generation by State by Type, State Historical Tables for 2011, released November 2012.

The Retail Competition Advocates go on to cite the success of the APS AG-1 rate as evidence that all customers can save money under deregulation. The "success" of the APS AG-1 rate is simply a function of the current difference between the wholesale market (indicative of short run marginal costs) and embedded costs. So, right now, a customer can buy from the market at a price below the APS embedded cost rate. But this condition is not sustainable nor could these prices be available to all customers. It is simply evidence of the instability of the price on a wholesale market that trades only a marginal amount of the total energy consumption, and a small number of customers taking advantage of the anomaly at the expense of the rest of the customers.[19]

It might be argued, what is wrong with that? If natural gas is cheaper, then let's use natural gas. This argument would totally ignore the volatility of the natural gas market. While we cannot predict future prices, we have to expect that exports to Mexico and the world markets, decreased output from wells, and environmental issues will put upward pressure on price. The need for a balanced portfolio to mitigate fuel market swings is demonstrated in the chart below. In other words, the current situation in Texas is likely not a sustainable one.



[19] Because these few customers are not covering the long run marginal costs that must be recovered to operate the system long term.

None of the competitive plans would provide a real advantage to most Arizona retail customers. According to EIA data, Arizona's annual average residential retail rate for 2012 is lower than that of 12 of 13 deregulated states, with Texas's rate being 0.0725 cents per kWh less than Arizona's. SRP's 2012 average residential retail rate is lower than that of every deregulated state.[20] More importantly, these prices are not sustainable as even ERCOT has stated that retail prices must increase to support new capacity.[21]

The logical conclusion from all of this is that deregulation does not fundamentally change costs, and it adds significant costs.

Unanswered Question 3: How does it benefit Arizona to lose control of its electricity destiny?

The proponents suggest that the Corporation Commission will still oversee a deregulated market. But, by definition this is not true. Arizona will lose significant oversight over its electric industry.

First, there is the generation component. Currently the Corporation Commission oversees long term planning and generation construction. It is able, along with the utilities, to plan for Arizona's future. Not so in a deregulated market. The *market* determines what generation is built, the type of generation and the location of generation. To the extent that there is any regulation, it is at the wholesale market with FERC oversight.

Then there is the price component. Currently the Corporation Commission insures that customers pay only just and reasonable prices based on cost of service. Assuming that the Arizona Constitution would allow deregulation, then the Corporation Commission loses the ability to set retail prices. To the extent that there is regulation, it is at the wholesale market level, controlled again by FERC.

The Commission also loses control of transmission and markets. Some advocates suggest that Arizona might form its own RTO, but this might be unrealistic because of the expense involved. The likely result of deregulation is that Arizona will join the California ISO, as identified by the Goldwater Institute. This would mean that Arizona transmission and market policies would be dominated by California politics. The Commission would have little role.

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[20] Average Retail Price of Electricity, U.S. Energy Information Administration. Data Browser. Available at http://www.eia.gov/electricity/data/browser/#/topic/7?agg=0,1&geo=hvvvvvvvvvvvo&endsec=e&freq=Q&start=200101&end=201301&ctype=linechart&ltype=pin&maptype=0&rse=0&pin=

[21] Interestingly, the large customers in Texas are opposing any effort to increase prices or establishing a capacity market, because they understand that these changes will cause them to pay the costs of maintaining reliability through capacity additions. http://www.reuters.com/article/2013/08/08/utilities-texas-idUSL1N0G917K20130808.

The Commission would be left to assume the role of policing energy service providers. While important, the Commission's authority to make a difference in Arizona's future would be gone.

Unanswered Question 4: Exactly what are the innovations that we might expect to see?

The proponents argue that there will be increased choice and innovation under deregulation.[22] They point to free dinners and free electricity on the weekends as examples of this. The argument is a generic one, and clearly does not hold water in Arizona.

Currently, Arizona may have the most choice of any state in the nation. All of the Arizona utilities offer significant options and choices to customers, not gimmicks. These include various time of use options, solar options, prepay options[23], levelized bill options and many more.

Very recently (July 23, 2013) J.D. Power issued ratings in a new classification. Called the Customer Awareness Survey, this inaugural study measures the level of residential customers' engagement with their electric utility's programs, products and services, and is based on responses from customers of electric utilities throughout the United States and Canada. The report cites five utilities who performed particularly well in overall customer engagement: **APS**; Clark Public Utilities; **Salt River Project**; Seattle City Light; and SMUD. Two of the five utilities are in Arizona; none are in deregulated areas.

Additionally Arizona utilities are proactively developing new programs and options, constantly listening to its customers to assess the needs and desires. And, customers are happy. SRP, APS and TEP consistently rank at the top of customer satisfaction surveys.

This is not the case in deregulated states. For example, Direct Energy's and Constellation's (served by StarTex Power, a subsidiary of Constellation) residential options in Texas are limited to fixed, variable or prepay plans with no true time of use options available.

In Texas, as in other areas, the volume of customer complaints have skyrocketed since the market was deregulated.[24]

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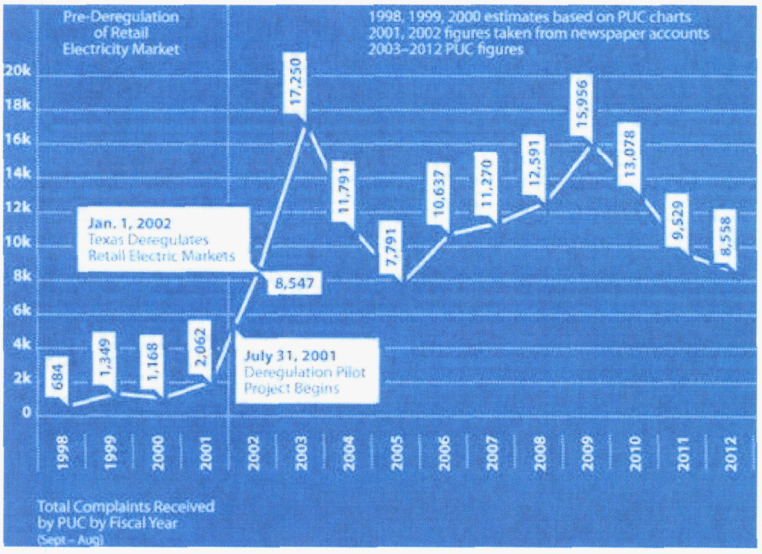
[22] In fact NRG comes out and says that competition is not about price, it is about service. Certainly there have been states where better service was a driver, but not here.

[23] SRP's prepay program called M-Power is the most successful in the nation with over 140,000 residential customers electing this payment plan. http://www.srpnet.com/payment/mpower/default.aspx

[24] Texas Coalition for Affordable Power, *Deregulated Electricity in Texas, A History of Retail Competition*, Page 76 (December 2012). Available at http://tcaptx.com/wp-content/uploads/2013/03/SB7-Report-2012.pdf



The proponents also argue that competition will produce innovation. But, they cite to no actual innovation. Instead they cite to emerging technologies: micro-grids, demand response and energy storage. These innovations will be driven by research and technology, not the way that a particular state structures its electric industry. These are not being developed by power marketers only for deregulated states.

In fact, most if not all of the innovations in the electric industry have come from the regulated entities. Retail suppliers must cut costs to the bare bones to be competitive; they don't have room to innovate or to invest in research and development. The proponents have not pointed to a single instance where retail competition has lead to an innovation in the industry.
The argument that deregulation will bring greater *meaningful* choice and innovation to Arizona is just not true.

Unanswered Question 5: Who is going to pay for all of this?

At least some of the proponents argue that restructuring is simple and that little is required to implement it. Yet the more sophisticated of the proponents set out an extraordinarily complex and expensive process to restructure the industry. The process, according to the Goldwater Institute, will play out over seven to eight years. It will cost hundreds of millions of dollars, all to be paid by Arizona electric customers.

Let's look at the proponents own statements. The Goldwater Institute sets out a nine point "plan" (which in and of itself is extensive). But, really there are more. Here is an outline of the major tasks cited by the Goldwater Institute (and this does not even address all of the issues that would arise):

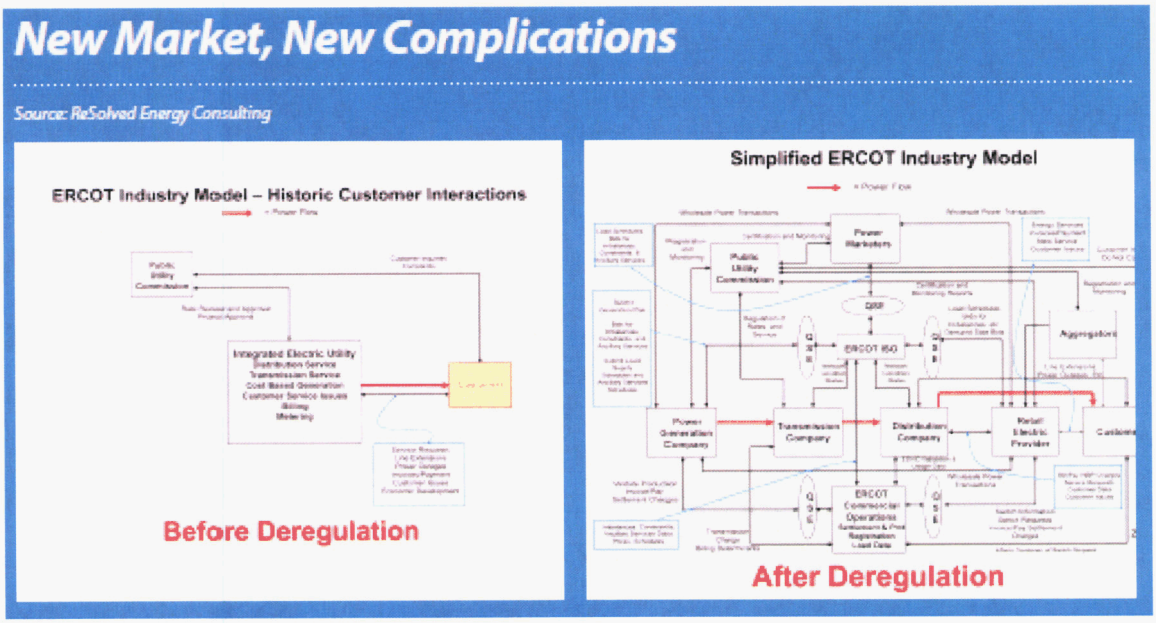
- Form an RTO to manage network operations
- Form an RTO to manage all transmission
- Form an RTO to control transmission investment
- Form an RTO to "control generation at each generation plant"
- Force initial divesture
- Force incumbent utilities to break into separate companies
- Create a real time electricity market
- Create a day-ahead market
- Create a "variety" of ancillary markets
- Create an "extensive" data exchange system, including prices and quantities at 15 minute increments
- Create financial transmission rights to be traded in RTO markets
- Provide for transmission hedging through an auction process
- Create a "complex" system connection process
- Force horizontal divestiture, so that generation is owned by many owners
- Establish wholesale market bidding rules
- Establish "market monitors"
- Eliminate renewable mandates
- Establish a separate renewables market
- Require that all customers make an "active choice" of a new generation supplier
- Create a secondary retail market for renewables
- Embark on a process of consumer education
- Establish retail markets for dynamic price swings
- Establish retail markets to manage ancillary services

The Retail Competition Advocates approach the issue without setting out a plan. But, the Retail Competition Advocates do identify tasks. We counted 39 separate tasks from the Retail Competition Advocates position paper, adding to those identified by the Goldwater Institute:

- Provider of last resort responsibility
- Establish retail market rules and protocols
- Evaluate metrics
- The exercise of customer choice
- Residential migration to competitive supply
- Non residential migration to competitive supply
- Customer value and savings
- Abundant product and service options
- Market entry and participation by retail suppliers
- Retail service transition considerations
- Customer protection issues
- Issues regarding access to customer information

- Permissible municipal aggregation programs
- Purchase of utility receivables (when switching)
- Supplier consolidated billing
- Meter issues relating to access, security, management and ownership
- Commencement of Competition
- Certificates of Convenience and Necessity
- Services required to be made available
- Recovery of stranded costs
- System benefit charges
- Transmission and distribution access
- In-state reciprocity
- Rates
- Service quality
- Safety
- Reporting requirements
- Administrative requirements
- Separation of monopoly and competitive services
- Disclosure of information
- Congestion management
- Divestiture or separation requirements and rules
- Determine how to deregulate given the provisions of the Arizona constitution
- Determine how energy efficiency and renewable standards will be met in a restructured environment
- The participation of public power

These are complex proposals. The pre- and post-deregulation structure of ERCOT is a great example of such complexity.[25]



And, given that no jurisdiction has yet to get it right, there will be no end to the complexity.

But, the real problem is the cost imposed on customers. The overall cost of the transition will be in the hundreds of millions of dollars. This includes the tasks listed above, plus addressing the long term capacity issues and policing power marketers. It includes the

[25] Texas Coalition for Affordable Power Deregulated Electricity in Texas. A History of Retail Competition. Page 21 (December 2013). Available at http://tcaptx.com/wp-content/uploads/2013/03/SB7-Report-2012.pdf

very large costs to the utilities to retool their systems to interact with a restructured system. It includes the high cost of initial and continuing customer education and monitoring. Finally it includes the very large added cost to the Corporation Commission over the years that it will take to develop the issues and defend the inevitable litigation.

No proponent suggests how to pay for this. Certainly none of them are volunteering to invest the money. The supposition appears to be that Arizona electric customers will foot the bill. That is not fair.

Discussion of Specific Proposals

Only the Goldwater Institute and AECC offered specific proposals for Arizona. SRP responds to each of these.

The Goldwater Institute

The Goldwater Institute position paper reflects the classic theoretical economist approach based on the proposition that if everyone would just get out of the way, markets will magically solve everything. It ignores the realities of operating an electric system. It is the same theoretical approach that caused the disaster in California.

Even if the theory is accepted, the proposal is seriously flawed. The proposal makes numerous factual and policy errors, using data in a biased way to support its conclusions.

Here are some examples of what is wrong or what is missing from the Goldwater Institute proposal:

1. *Long term planning.* The Goldwater Institute claims that "there is no evidence that competition has done anything to discourage the expansion of generation capacity", claiming that from 1998 to 2010 capacity increased in Texas by 45% compared to a state growth in GDP of 39%.[26],[27] This is not correct.

First, the Goldwater Institute ignores the fact, as discussed above, that there is a critical capacity shortage right now in Texas. Its statement ignores actual load growth.

Second, the Goldwater Institute seems to confuse capacity with energy, citing to the addition of tax-incentivized wind turbines as capacity additions. In fact, over one-third of generation added in Texas since 2000 has been federally-subsidized wind generation.

Third, the report seems to equate capacity with number of megawatts added, without taking into account whether those MWs are available at the peak hour of demand (the

[26] As in much of the report there are no sources cited for these statistics.
[27] A Time for Choosing: Why Choice and Competition in Electricity are Right for Arizona, Goldwater Institute Policy Brief No. 260, July 12, 2013.

traditional industry definition of capacity). Any proper analysis of growth in industry capacity has to look at reserve margins (i.e., the amount of reserve capacity available at the time of system peak), which is the primary basis used by the industry to ensure that generation is available to meet customer needs.

2. *Selective statistics and failure to look at the big picture.* The data presented on prices paints a false and misleading picture.

First the Goldwater Institute only looks at two states, not the whole of the deregulated markets, over a time period of 2008 to 2010. This time period corresponds exactly to the beginnings in the decline of natural gas prices in the US, when prices declined by almost 50%. A proper analysis would look at the totality of the evidence over a longer period in both regulated and unregulated states.

Second, the Goldwater Institute ignores recent studies that suggest that retail competition and restructuring have not lowered retail rates compared to regulated markets, and in fact the differences may be increasing. Many of these studies have been produced. We particularly direct your attention to the study set out on page 5 of this position paper.

3. *Deceptive statistics on the Texas situation.* The Goldwater Institute report also attempts to demonstrate that competitive offers in Texas are often below the so-called "price to beat". Beyond the obvious absurdity of comparing 2011 regulated rates with 2013 offers as the Goldwater Institute chart does (worse than an apples to oranges comparison), the data tells us nothing. As the Goldwater Institute itself points out later in its report, the default price in Texas has been artificially increased over the years to encourage shopping. And of course the "shopping price" will always be below the default price to beat. We know nothing about the terms and conditions associated with these supposed offers and what costs they cover and do not cover. The Goldwater Institute ignores the fact that customers were forced to choose alternative providers (Texas), when offering statistics of percentages of customers who switched suppliers.

4. *Misunderstanding of reliability issues.* The Goldwater Institute's response to ensure continued reliability is to require new retail suppliers to post a "reasonable bond to protect against lost service". But, retail suppliers have no control over whether or not generation will be available to meet the needs of their customers, unless they build their own generation or enter into long-term contracts. If generation isn't available, financial penalties won't cure the situation.

5. *Recovery of costs.* There is no recognition of the tremendous costs of the many systems and markets suggested by the Goldwater Institute, or a recognition of who will finance them. The cost of the proposal will be hundreds of millions of dollars including the costs of set up, the costs of the bells and whistles suggested by the Goldwater Institute, the costs to the utilities to transition to these systems, the cost of customer education, and the costs of operating and maintaining all of these systems and functions.

6. *There is no assurance of innovation.* The Goldwater Institute talks about innovations such as battery storage and micro-turbines. But, these are not available at reasonable prices, in spite of significant ongoing research and development. Interestingly as these innovations become commercially available, they will be adopted regardless of the market structure. There is no evidence that deregulated states adopt these technologies more than other states. More importantly there is no evidence that any of the power marketers are engaged in the research necessary to bring innovations to market.

7. *Uniqueness of the electric industry.* The Goldwater Institute analogizes electricity to telephone service, totally ignoring the vast differences between these commodities: very large price of entry, electricity cannot be stored, loads and resources must be precisely matched at all times, reliable electricity is essential to life and customers have no choice but to purchase electricity (they cannot do without).

8. *Price volatility.* The Goldwater Institute does not address price volatility. The answer of Goldwater Institute is to price according to current market price, regardless of fluctuations.

9. *Existing resources.* The Goldwater Institute does not explain how the major plants serving Arizona, such as the Navajo Generating Station and Four Corners, would be viable, other than loose talk of a federal tax credit (which would not apply to the majority of the ownership).

10. *Market manipulation.* The Goldwater Institute fails to understand the issue of market manipulation. The Goldwater Institute acknowledges that "experience has shown that electricity markets are more vulnerable to the exercise of market power than other markets". But then it asserts that competitive markets are "transparent". This statement ignores the fact that market transparency has in fact been one of the key problems with competitive markets. This year alone FERC has either entered into settlement agreements or assessed penalties totaling nearly a billion dollars for market manipulation. For example, JP Morgan - $410 million settlement, Barclay's - fined $487 million, Constellation Energy - $245 million settlement. While this manipulation is at the wholesale level, consumers in deregulated markets are more directly impacted by wholesale market manipulation because their pricing more closely reflects wholesale prices.

11. *Developments in Arizona.* The Goldwater Institute is not in touch with the current developments in Arizona. For example it advocates the adoption of smart meters, ignoring the fact that most Arizona customers already have smart meters. It also calls for time of use pricing, ignoring the fact that SRP customers have (and have had for decades) a number of time of use options.

The Goldwater Institute proposal is not a realistic plan for Arizona.

The AECC[28] proposal

Whether AECC makes a proposal or not is not clear. It appears from the answers to the questions that AECC is suggesting that Arizona simply "reinstate" competition, without doing anything else. Apparently AECC is suggesting that competition be reinstated for "all customers" with:

No provider of last resort
No RTO
No transmission mandates
No stranded costs
No market rules
No change in long term planning

It is hard to take this suggestion seriously. We only need to look at tasks identified by the Goldwater Institute and by Retail Competition Advocates to understand the years of work that will be needed to restructure the industry. There is no state which has implemented anything like what is proposed by AECC. No economic theory would support it.[29]

The consequences of this proposal are obvious. With all customers having the right to leave the system with no consequence, customers will come and go, perhaps in droves, based solely on the short-term market price. This will leave nobody with the incentive or ability to maintain the long term reliability of the electric system. The incumbent utilities cannot do it because they have no assurance of a customer base. The power marketers cannot do it because there is no mechanism to provide for long term investment.

The result of the AECC proposal would be a free fall of the system, with years of litigation and uncertainty. Major investment and planning would stop. Arizona would be paralyzed.

The AECC paper is confusing because after suggesting that competition simply be "reinstated" for "every customer class", AECC discusses the Oregon "Minimum Five Year Opt-Out Program", which applies only to large customers. This is an approach that could be worse than full deregulation.

The Oregon program cited by AECC applies to one utility, Portland General Electric. It was developed by the Oregon PUC to address the failure of the Enron-owned PGE to develop

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[28] AECC does not identify a single entity member in its filing. As the list of supporters on the web site seems to change regularly, we cannot attribute these comments to any particular entity.

[29] AECC mentions the Oregon "model". This is not really deregulation, it is a limited program for a few large customers, much like the APS AG-1 rate. Recently Oregon has recognized that the program shifts costs to residential and small business customers. It is looking to modify the program.

capacity prior to and during its bankruptcy.[30] It was envisioned as a measure to remedy the capacity deficient utility by moving a fixed amount of retail load to the market.

Now PGE is healthy and is planning for the future (including those customers who may come back to the utility). This means that it is no longer capacity deficient. Because it has developed and maintains capacity to service its customers, it is failing to cover cost for customers who leave the system indefinitely under the program.

The result is that the program is now shifting costs to other customers. This point was made clear by testimony filed on June 14, 2013 by George R. Compton, Senior Economist, employed in the Rates, Finance, and Audit Section of the Energy Division of the Public Utility Commission of Oregon, in Docket UE 262, PGE's Request for a General Rate Revision:

> [Where] the cost-of-service loads goes down while costs (i.e., fixed generation costs) remain the same, then all the cost-of-service rate schedules will see an increase in their generation revenue requirement commensurate with their increased proportional share of the loads. The revenue requirement increases translate to price/rate increases.[31]

Mr. Compton went on to testify to the same point being made by the opponents of deregulation in this docket:

> I must add that given the standard lead times and long-term commitments for major generation units, and given the requirement of the utility to meet all qualifying demands on a cost-of-service basis, one can't arbitrarily drop resources from a cost estimate based upon speculation regarding what loads may or may not materialize.[32]

The utility, PGE, agreed that costs are being shifted. In its response to Staff's data request number 311 the Company said:

> From PGE's perspective, the opportunity for customers to permanently leave COS [cost-of-service] on an annual basis gives participants the opportunity to shift costs to non-

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[30] PGE was owned by Enron Corporation from 1997 until 2006 when Enron divested itself of PGE during its bankruptcy.

[31] Oregon Public Utility Commission, Docket: UE 262 PGE's Request for a General Rate Revision Staff Exhibit 300. Opening testimony of George R. Compton, at P. 7, June 14, 2013.

[32] *Ibid.* at page 8.

> participants. This cost shift is accomplished by the re-spreading of fixed generation costs to non participants.[33]

PGE has consistently emphasized the cost shifting in its program, making similar points in a separate docket dedicated to the Multi-Year Opt-Out program:

> The current mix of options provides participating large nonresidential customers an opportunity to unduly shift costs to other customers who do not select a long-term direct access option. Furthermore, this opportunity for participants to shift costs to nonparticipants is currently made available every year.[34]

The challenge to Oregon is to remake the program so that it does not shift costs. But, if that happens, the program likely will no longer be attractive as, absent cost shifting, there will be no savings.

The Oregon approach is the worst of all worlds. It threatens long term planning, it shifts costs, and it totally favors a few large customers at the expense of many residential and small business customers. Worse yet, it creates untenable uncertainty. The utility has no way of knowing if or when a customer will return with enough time and certainty to procure necessary resources And the utility does not know whether the program will be expanded or ended. It therefore cannot adequately plan for the future. As such a program plays out (and it takes some time), it would be more and more difficult to finance and build new facilities.

SRP strongly recommends against the Oregon approach.

Conclusion

SRP has a proposal that works. The proposal is to not make any precipitous changes that might put Arizona at risk. Rather, the Corporation Commission, and all of us in Arizona, should closely watch and monitor the changes that are occurring in the electric industry. By doing this the Corporation Commission can consider change, if appropriate, in a natural and safe way, as may be suggested by new technologies and opportunities.

SRP requests that the Corporation Commission close this docket.

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[33] Oregon Public Utility Commission. Docket UE 262. PGE's Request for a General Rate Revision. Staff Exhibit 300. Opening Testimony of George R. Compton, p. 7, June 14, 2013

[34] Pre-filed Testimony of Marc Cody, Oregon Public Utilities Commission, Docket: UE 236 PGE's Multi Year Opt-Out Window, November 9, 2011, p. 5.