

**Customer Choice Committee Report and Recommendations
to the Board of Directors on Rehearing of the December 7, 1998 Resolutions
February 1999**

I. INTRODUCTION

On December 7, 1998, the Board of Directors ("Board") of the Salt River Project ("SRP") adopted three resolutions pertinent to the provision of competitive electric services within SRP's service territory (collectively "December 7th Resolutions"). The December 7th Resolutions are as follows:

1. The "Resolution Of The Board Of Directors Of The Salt River Project Agricultural Improvement And Power District Setting Forth A Final Decision On Rehearing Of The August 14, 1998 Resolution Adopting Terms And Conditions For Competitive Electric Services" ("Rehearing Resolution");
2. The "Resolution Of The Board Of Directors Of The Salt River Project Agricultural Improvement And Power District Setting Forth A Final Decision Adopting Revised Terms And Conditions For Competitive Electric Services" ("Revised Terms and Conditions Resolution"); and
3. The "Resolution Of The Board Of Directors Of The Salt River Project Agricultural Improvement And Power District Adopting Unbundled Electric Price Plans And Related Matters" ("Pricing Resolution").

The Board adopted the December 7th Resolutions following an extensive public process, and in accordance with the Electric Power Competition Act ("Act"), which became effective on August 21, 1998. The Board based its decisions on the record

evidence in the competition proceeding, the rehearing of the August 14, 1998 resolution, the reconsideration of the terms and conditions, and the pricing proceeding. The record includes proposals by SRP Management ("Management"), analysis papers and presentations by consultants, comments from customers and the public, documents in the Information Room, and the Customer Choice Committee's reports.

The Act allows any party to the competition proceedings, or the Attorney General, to apply for rehearing of the Board's decisions. Specifically, A.R.S. §30-810(A) provides that:

After any final order or decision is made by the governing body of the public power entity regarding terms and conditions for customer selection, complaint resolution, consumer protection, stranded costs, transmission and distribution service rates and charges, system benefit charges and related matters as determined in the reasonable discretion of the governing body of the public power entity, or regarding compliance with an intergovernmental agreement made under the provision of this chapter, any part to the action or proceeding or the Attorney General on behalf of the State may apply for rehearing of any matter determined in the action or proceedings and specified in the application for rehearing within twenty days of entry of the order or decision.

On December 23, 1998, the Arizona Consumers Council ("Consumers Council") filed an Application for Rehearing of the Pricing Resolution ("Application for Rehearing on Pricing") and an Application for Rehearing of the Rehearing Resolution and the Revised Terms and Conditions Resolution ("Application for Rehearing on Terms and Conditions"). On December 28, 1998, the Office of the Attorney General ("Attorney General")¹ and Tucson Electric Power Company ("TEP") each filed an Application for

¹ In its Application for Rehearing, p. 1, para. 1, the Attorney General seeks rehearing on three Resolutions, including a "Resolution . . . Setting Forth a Final Decision Adopting revised Terms and Conditions for Competitive Electric Services amending the Resolution respecting Terms and Competition, adopted by the Board on August 14, 1998." There is no Resolution with that title. For purposes of this report the Customer Choice Committee will assume that the Attorney General is referring to the Rehearing Resolution.

Rehearing of the December 7th Resolutions. The applications were timely filed and alleged error in various aspects of the conduct of the competition proceedings and the substance of the Board's decisions.

On January 4, 1999, the Board granted rehearing to consider the matters raised in the applications, with one exception. The Board did not grant rehearing on the portion of the Attorney General's Application for Rehearing pertaining to the Code of Conduct. The Code of Conduct was adopted by Resolution dated November 9, 1998 and the time for filing a request for rehearing on that matter had already expired. The Board appointed the Customer Choice Committee to conduct the rehearing and to make a report and recommendation to the Board.

On January 29, 1999, Management filed its Brief in response to the Applications for Rehearing.

Rehearing was held on February 5, 1999. At the rehearing, Consumers' Council and Management presented oral arguments. The Attorney General declined the opportunity to speak, and no public comments were received. TEP did not attend the rehearing.

The Customer Choice Committee has reviewed and given careful consideration to the Applications for Rehearing, the oral arguments and evidence presented in support of the applications, and Management's arguments and evidence in response to the applications. Based on our review of the record, the Customer Choice Committee has prepared this report to discuss the issues raised on rehearing, and to present our findings and recommendations to the Board. We incorporate the record the competition proceeding, the rehearing of the August 14, 1998 Resolution ("August 14th Resolution"),

the reconsideration of the terms and conditions, the pricing proceeding, and this rehearing proceeding into this report by reference.

II. AUTHORITY TO RECOVER STRANDED COSTS

The Rehearing Resolution adopted a finding that SRP's authority to set rates under A.R.S. §48-2334(E), in conjunction with its authority to establish a surcharge to recover stranded costs under A.R.S. §30-805(A)(3), provide the requisite legal basis for stranded cost recovery. A.R.S. §48-2334(E) grants to the Board the authority to make decisions on proposed changes to the standard electric rates. A.R.S. §30-805(A)(3) provides for the recovery of stranded costs and empowers the Board to "establish a surcharge on electric distribution service to pay for all or a portion of the unmitigated stranded costs of electric generation service. . . ." The Recitation of Authority sections in each of the December 7th Resolutions includes these provisions as authority for the decision of the Board. The Applications for Rehearing challenge this authority as the legal basis for stranded cost recovery.

The Consumers Council asserts that SRP is not entitled to recover stranded costs as a matter of law and fact. (Consumers Council Application for Rehearing on Terms and Conditions, para. 8).

TEP contends that SRP is not entitled to recover stranded costs because it has no stranded costs. According to TEP, the right to recover stranded costs arises only from the regulatory compact, which obligates the State to allow just and reasonable rates in exchange for the service obligations imposed on public service corporations. Under TEP's theory, the costs incurred by a public service corporation pursuant to its obligation to provide service in a monopoly environment that become stranded in the transition to a competitive marketplace are recoverable only by virtue of the regulatory compact that imposed the service obligations and caused the stranded costs to be

incurred. Since SRP's rates were never regulated by the State and SRP has not been a party to the regulatory compact with the State, TEP contends that SRP does not have stranded costs. Since SRP does not have stranded costs, TEP contends that SRP cannot claim stranded cost recovery under the authority of A.R.S. §30-805. (TEP Application for Rehearing, pp. 2-6).

The Attorney General argues that SRP has no legal claim to the recovery of stranded costs. According to the Attorney General, legal entitlement to the recovery of stranded costs only arises from a regulatory taking that caused the costs to become stranded. The Attorney General believes that public service corporations may claim stranded costs because deregulation affects their property rights and their ability to recover certain governmentally-mandated costs, but that the advent of competition for SRP has occasioned only an economic loss, not a constitutional taking of property. Without this regulatory taking, the Attorney General contends that A.R.S. §§30-805(A)(3) and 48-2338 do not offer sufficient legal foundation for SRP to recover stranded costs. (Attorney General Application for Rehearing, pp. 3-5).

In response to the Applications for Rehearing, Management maintains that SRP does have stranded costs and the authority to set prices to recover those stranded costs. Management cites to A.R.S. §48-2334, which grants SRP the authority to charge prices based on the cost of service. As explained by Management, unbundling stranded costs from current prices and providing for their recovery over a limited term falls within the authority set forth in A.R.S. §48-2334. That authority, according to Management, is reaffirmed by the provisions of A.R.S. §30-805, which authorize stranded cost recovery and establish certain parameters for recovery.

Management disagrees with TEP's contention that the right to recover stranded costs arises only from a regulatory compact. It is Management's position that the existence of a regulatory compact is irrelevant to SRP's authority to recover stranded costs. Management argues that requiring a regulatory compact would impose a condition on stranded cost recovery that a public power entity could never meet, that would be contrary to SRP's express statutory authority, and that would render the provisions of A.R.S. §30-805(A)(3) meaningless. Management further argues that the regulatory compact principle is advanced by public service corporations to explain why they are entitled to recover stranded costs, but that the principle does not relate to the authority of the regulator to allow the recovery of stranded costs.

As explained by Management, the public policy foundation for stranded cost recovery by public power entities differs from the public policy foundation for stranded cost recovery by public service corporations. The Act expressly authorizes the recovery of stranded costs by public power entities, and does so without conditioning recovery on the existence of a regulatory compact, whereas there is no such express statement of policy or authority for the recovery of stranded costs by public service corporations. (Management Brief, pp. 1-5).

The Customer Choice Committee finds that the Board correctly determined that SRP's authority to set rates under A.R.S. §48-2334(E), in conjunction with its authority to establish a surcharge to recover stranded costs under A.R.S. §30-805(A)(3), provide the requisite legal authority for stranded cost recovery. The combined authority conferred by those provisions permits SRP to lawfully recover its stranded costs. Under the authority conferred by A.R.S. §§30-804(A)(3) and 48-2443(E), there is no

requirement that a regulatory compact or regulatory taking be established as a condition precedent to stranded cost recovery by a public power entity. The regulatory compact and regulatory taking concepts pertain to the entitlement of public service corporations to recover stranded costs; by law, they are unrelated to the authority of SRP, as a public power entity, to recover stranded costs. We recommend that the Board reject the arguments of the Consumers Council, TEP, and the Attorney General.

III. TUCSON ELECTRIC POWER COMPANY

A. DIVESTITURE

In its Application for Rehearing, TEP alleges that the December 7th Resolutions violate A.R.S. §30-802(A) by failing to require that SRP divest (*i.e.*, sell to a third party) or spin off (*i.e.*, transfer to an affiliate) its generation assets as a condition to stranded cost recovery. TEP claims that Arizona Corporation Commission (“ACC”) rules on stranded cost recovery contemplate divestiture or spin off of public service corporation generation assets and that SRP’s failure to undertake divestiture or spin off violates A.R.S. §30-802(A), which requires coordination between public power entities and the ACC. TEP contends that divestiture by SRP is neither impossible, illegal, or impractical. TEP contends that, in order to ensure full and fair competition in a coordinated statewide manner, SRP must spin off all of its generation assets into a separate, affiliated company and prohibit that affiliate from selling electricity to SRP at terms more favorable than to other companies. (TEP Application for Rehearing, pp. 6-7).

Management maintains that there is no legal requirement for divestiture or spin off and that the Board acted within the scope of its reasonable discretion in rejecting those options. As explained by Management, the Act does not require SRP to physically separate its generation assets. Rather than requiring either divestiture or spin off to separate the competitive and noncompetitive activities of providing electric service to customers, the Act adopted the Code of Conduct approach to functionally separate the activities of a public power entity. In addition, Management contends that divestiture by SRP would be very detrimental to customer interests, would result in higher prices for customers, and would eliminate the advantages of a dedicated, stable

generation supply.

With regard to the ACC's rules, Management contends that, contrary to TEP's argument, there is no legal requirement that public service corporations undertake divestiture. The ACC rules provide divestiture as an option, not a requirement. Management further contends that, since the ACC's rules have been stayed and are subject to further consideration, it is uncertain whether divestiture or spin off will be the ultimate solution selected by the ACC. (Management's Brief, pp. 9-10).

The Customer Choice Committee has previously considered TEP's argument on this issue and found it to be premised upon a misconstruction of A.R.S. §30-802(A). We do so again. TEP argues as if that statute required SRP and the ACC to adopt identical terms and conditions for the provision of competitive electric services. That is not what the statute says. A.R.S. §30-802(A) requires public power entities and the ACC to "coordinate their efforts in the transition to competition in electric generation service to promote statewide application of their respective rules, procedures and orders." That language neither mandates the adoption of identical provisions nor grants superiority to the ACC's rules over the terms and conditions of public power entities. In fact, by requiring public power entities and the ACC to undertake coordination efforts, the statute tacitly recognizes that different approaches will exist.

Further, SRP and the ACC have for several years been, and continue to be, engaged in coordination efforts. As described by Management, over 400 separate meetings involving SRP and the ACC have occurred on virtually every subject area related to the transition to competition. This interaction between SRP and the ACC establishes that coordination efforts have been extended and extensive.

For these reasons, and based upon the arguments offered by Management, the Customer Choice Committee finds that the Board's decision against divestiture or spin off of SRP's generation facilities does not violate A.R.S. §30-802(A). We recommend that TEP's Application for Rehearing on this issue be denied.

B. INDISPENSABLE PARTY

TEP contends that the United States should have been made a party to the competition proceedings because it has a proprietary and sovereign interest in SRP and in the uses to which SRP's assets are devoted. According to TEP, if, as Management claims, it is the federal interest that makes divestiture or spin off of generation assets impossible, then the United States should publicly participate in this proceeding and address that point. TEP alleges that since the United States is an indispensable party, but did not participate in the competition proceedings, the Board's adoption of the Resolution was premature and it must be approved by the United States. (TEP Application for Rehearing, pp. 8-9).

Management disagrees with TEP. In its Brief, Management explains that the September 6, 1917 contract between the United States and SRP conferred upon SRP the right of possession and the obligation for the care, operation, and maintenance of the project. The contract reserves for the United States only the rights to inspect the project, to have full and free access to the books and records, to make reasonable rules and regulations, to give (or withhold) prior approval of any "substantive changes" in any project works, to give (or withhold) prior approval of power contracts with a term exceeding one year, and to terminate the contract in limited circumstances. Management asserts that nothing in the 1917 contract, or the subsequent 1937

contract, requires the federal government to participate in, or otherwise ratify, the terms and conditions under which SRP operates its electric power business. (Management Brief, pp. 11-12).

The Customer Choice Committee finds that TEP has raised no new arguments or presented no new evidence on rehearing that persuade us that the December 7th Resolutions erred by determining that the United States is not an indispensable party to these competition proceedings. The Customer Choice Committee, therefore, again finds that TEP's contention is without merit. Whether the United States should be deemed to be an indispensable party to the competition proceedings depends upon its interests and rights in the project, as defined in and conferred by the 1917 and 1937 contracts. We concur with Management that the interests and rights enumerated in the contracts do not require the United States to approve terms and conditions for the project's operation. Absent that contractual interest or right, the United States is not an indispensable party to these proceedings to establish the terms and conditions for competitive electric service.

IV. ATTORNEY GENERAL

A. STRANDED COST RECOVERY

In addition to challenging the authority of SRP to recover stranded costs, as discussed above, the Attorney General on rehearing takes issue with both the concept that stranded costs should be recovered and the mechanism for recovery. The Attorney General alleges that: SRP has misled customers by including additional costs in the Competitive Transition Charge ("CTC") and falsely labeling them "stranded costs"; the recovery of SRP's operating costs as "stranded costs" insulates SRP from the effect of inefficient operations; stranded cost recovery is a disguised rate increase and the Board falsely promised a rate decrease; the conversion of a rate increase into the CTC is anti-competitive and will have profound effects on SRP's market share; SRP's stranded cost recovery plan is similar to that proposed by Arizona Public Service Company ("APS") and may be a product of unlawful collusion in violation of federal and state antitrust laws; and setting the CTC as a fixed charge per kilowatt hour will skew customer consumption decisions and present a barrier to market entry by competitors. Based on these allegations, the Attorney General contends that SRP's stranded cost recovery and CTC violate the Act. (Attorney General's Application for Rehearing, pp. 5-7).

Management disputes the Attorney General's allegations. Management asserts that the recovery of stranded costs and the CTC recovery mechanism were established by the legislature as the proper approach to the transition to a competitive market. If the Attorney General disagrees with that approach, Management suggests that the Attorney General's quarrel lies with the legislature, not SRP. Management defends SRP's determination of stranded costs as being consistent with the provisions of the Act and

not a disguised rate increase. Management asserts that, contrary to the Attorney General's allegations, there is no price increase. As explained by Management, the stranded cost recovery approach enacted by the legislature unbundles the rates in effect at December 30, 1998 and moves the stranded cost element included in those rates to the CTC. Management additionally cites to A.R.S. §30-805(B), which mandates that the CTC cannot cause an increase in the standard offer price effective December 30, 1998, and to A.R.S. §30-805(C), which requires that the CTC be allocated among customer classes "to effect a recovery of stranded costs that is in substantially the same proportion as the recovery of similar costs from customers or customer classes under current rates." As further support for its position that there is no price increase, Management points to the fact that SRP has reduced prices for its bundled offer customers by an overall 5.4 percent, based upon all price components, including the CTC. Management contends that the CTC recovers only prudently incurred costs that cannot be recovered in a competitive market, and does not provide for the costs of inefficiency. With regard to the similarity between the SRP and APS stranded cost recovery plans, Management avers that there have been no negotiations or agreements between SRP and APS on the subject of stranded cost recovery or methodology since the agreement with the Attorney General was entered into in May 1998.

The Customer Choice Committee finds that the Attorney General's argument is without merit. Overall, the argument is based on allegations that are untrue, that lack legal, factual, and or evidentiary support, and that reflect a misapprehension of the provisions of the Act and the determination of the CTC.

More specifically, the Attorney General is incorrect that SRP has mislead

customers by including additional costs in the CTC and falsely labeling them “stranded costs”. The costs included in the CTC are not new or additional costs. They are costs that had been included in prior bundled rates, but are no longer recoverable in a competitive market. As required by the Act, SRP’s stranded costs have been removed from base rates and a portion of the total stranded costs has been transferred to the CTC for recovery.

The Attorney General is incorrect that the calculation of stranded costs includes the cost of inefficiencies or insulates SRP from the effect of inefficient operations. The record establishes that only prudently incurred costs have been included in the stranded cost calculation and the Attorney General has offered no evidence to the contrary.

The Attorney General is incorrect that stranded cost recovery is a disguised rate increase and that the Board falsely promised a rate decrease. As discussed above, the stranded costs included in the CTC are not new or additional costs. There is no price increase. A.R.S. §30-805(B) and (C) expressly prohibit an increase, and SRP has complied with that law. Management at rehearing demonstrated mathematically not only that a price increase has not occurred, but that SRP has reduced its bundled offer price by an overall 5.4 percent.

The Attorney General is incorrect that a rate increase has been converted into the CTC and will have anti-competitive effect. Again, there is simply no increase.

The Attorney General is incorrect that SRP’s stranded cost recovery plan is in any way a product of unlawful collusion with SRP. As averred by Management, no negotiations or agreements have occurred between SRP and APS on the subject of stranded cost recovery or methodology since the agreement with the Attorney General

was entered into in May 1998. The stranded cost recovery determination adopted by the Board is consistent with the provisions of the Act and resulted from negotiations with SRP's large general service customers and the Residential Utility Consumer Office ("RUCO").

The Attorney General is incorrect that setting the CTC as a fixed charge per kilowatt hour will skew customer consumption decisions and present a barrier to market entry by competitors. The record establishes that applying the CTC to energy consumption, rather than as fixed charge per customer, is the most appropriate method to recover stranded costs which are generation related. The record further establishes that the CTC is not a barrier to market entry because all customers will be assessed the charge, whether they take service from SRP or from a competitor.

In accordance with the foregoing discussion, the Customer Choice Committee recommends that the Board deny the Attorney General's Application for Rehearing on this issue.

B. AGGREGATION

In its Application for Rehearing, the Attorney General challenges the directive in the Rehearing Resolution for Management to develop a proposal to reallocate any unsubscribed load within the 20 percent limit. The Attorney General maintains that this directive represents a serious barrier to immediate competition and violates A.R.S. §30-803(E), which requires SRP to permit aggregation without limitation. According to the Attorney General, SRP has no legal entitlement to control its customers and prevent them from obtaining every benefit competition has to offer. (Attorney General Application for Rehearing, pp. 5-6).

In response, Management argues that the Attorney General's position is not supported by a proper reading of A.R.S. §30-803(A) and (E). A.R.S. §30-803(A) implements competition in two phases, with the first phase to begin "not later than December 31, 1998 for at least twenty per cent of the 1995 retail load" and the second phase to commence not later than December 31, 2000 for full competition. A.R.S. §30-803(E) requires public power entities to "allow the aggregation of loads by multiple customers." Management contends that these provisions must be interpreted in accordance with two basic tenets of statutory construction: (1) statutes must be construed as a whole in order to achieve the legislature's goals (*Achen-Gardner v. Superior Court*, 173 Ariz. 48, 839 P.2d 1093 (1992)); and (2) statutes must be construed in harmony to avoid leaving any part of them superfluous, void, contradictory, or insignificant (*Estate of Ryan*, 187 Ariz. 311 928 P.2d 735 (App. 1996)). According to Management, if aggregation is permitted without limitation under A.R.S. §30-803(E), as the Attorney General suggests, then SRP could be forced to make competitive services available to more load than is required by A.R.S. §30-803(A). In other words, the Attorney General's interpretation would render the two provisions contradictory, which does not comport with basic statutory construction. (Management's Brief, pp. 6-7).

At the rehearing, Management discussed the implementation of competition that has occurred under the Act since the December 7th Resolutions were adopted. Management introduced evidence to show that every customer who timely requested the opportunity to participate in the first phase of competition was selected for participation. Management argues that this evidence demonstrates that SRP has fully complied with the statute by opening 20 percent of its load to competition and allowing

aggregation within the 20 percent limit. (2/5/99 Tr., pp. 28-31).

The Customer Choice Committee finds that the December 7th Resolutions properly rejected the Attorney General's position on aggregation. The argument made by the Attorney General is not supported by the law. While A.R.S. §30-803(E) does not impose a limit on aggregation, construing that provision in conjunction and in harmony with A.R.S. §30-803(A) leads but to one conclusion -- the law requires that SRP permit aggregation in Phase I only within the level of retail load required to be made available for competition. The December 7th Resolutions accomplish that objective and are, therefore, lawful. Further, the argument advanced by the Attorney General is not supported by fact. No customer request to aggregate load has been denied. In addition, the proposal that the Board has directed Management to develop on reallocating unsubscribed load to customers with multiple meters who request aggregation should assist in accommodating future aggregation requests. The Customer Choice Committee accordingly recommends that the Board reject the Attorney General's position on aggregation.

V. ARIZONA CONSUMERS COUNCIL

The Consumers Council filed an Application for Rehearing on Pricing and an Application for Rehearing on Terms and Conditions. The applications contain several similar arguments. Where appropriate, these arguments will be combined for purposes of discussion in this report.

A. CONFLICT OF INTEREST

1. Stranded Cost and Return on Capital Determinations

The Consumers Council alleges that the Board for the SRP Agricultural Improvement and Power District ("District") has an irreconcilable conflict of interest in the competition and pricing proceedings because all but two of its members also serve on the Board for the Salt River Valley Water Users Association ("Association"). In its Application for Rehearing on Terms and Conditions, Consumers Council alleges that the conflict arises because District's Board members have an absolute duty to mitigate stranded costs, which would include eliminating the water subsidy the District pays to the Association, but that the Association's Board members have an interest in preserving the water support. In its Application for Rehearing on Pricing, Consumers Council alleges that the conflict arises because the prices for electric services include a return on capital to generate funds to subsidize the cost of providing water to the Association's customers. The Consumers Council contends that these irreconcilable conflicts of interest disqualify dual Board members from making any decision on stranded cost recovery and return on capital. (Consumers Council Application for Rehearing on Terms and Conditions, para. 1, and Application for Rehearing on Pricing, para. 4).

Management disagrees that any legal conflict of interest exists. As explained by Management, the District has the responsibility to reduce the cost of water for landowners. A.R.S. §48-2302 authorizes the District to engage in certain water and power functions for the benefit of the owners and occupants of the lands within its boundaries, and to sell surplus water and power outside of its boundaries to reduce the cost of irrigation, drainage, and power to the landowners. The exclusive function of the Association is to act as the District's agent in accomplishing the water functions that the District is statutorily and contractually obligated to perform. Thus, it is the District that is the real party in interest, the economic substance of the water support payments does not affect the Association, and there is no conflict of interest. As further support for its position that no legal conflict of interest exists, Management cites to A.R.S. §48-2303)A)(7) that provides authority for the Board to use electric revenues to reduce the cost of water delivery.

In addition to disputing the legal basis for a conflict of interest, Management takes issue with Consumers Council's assertion that a conflict even exists. Management disagrees with Consumers Council's assertion there is a conflict between the duty of the District's Board members to mitigate stranded costs, by eliminating the water subsidy, and the interest of the Association's Board members in preserving the water support. Management cites to A.R.S. §30-805(A)(3), which requires that SRP mitigate the stranded costs of electric generation service. According to Management, the funds used to support water delivery are not a cost of electric generation service and do not increase the cost to generate electricity. Management, therefore, argues that the statute does not require elimination of the water subsidy to mitigate the

stranded costs of generation and that absent such a requirement, there is no conflict. A non-existent duty of the District cannot conflict with an interest of the Association.

Management also disagrees with Consumers Council's assertion that a conflict arises because the prices for electric services include a return on capital to generate funds to subsidize the cost of providing water to the Association's customers. Management submits that, from a municipal law perspective, it is entirely proper and customary for a public entity to earn a return on its assets devoted to providing service to its constituents and to use those funds for other authorized purposes. See McQuillan, *The Law of Municipal Corporations*, Section 35. 37.20. Since under A.R.S. §48-2303(A)(6) support of water operations is an authorized purpose, Management argues that use of the earned return to support water delivery service is permissible and that there is no conflict. (Management Brief, pp. 13-15).

The Customer Choice Committee finds that, contrary to the allegations of the Consumers Council, no legal conflict of interest arose from the participation of dual Board members in the determinations of stranded costs and return on capital contained in the December 7th Resolutions. A.R.S. §48-2303(A)(7) expressly empowers the Board to use electric revenues to reduce the cost of water delivery. Given this statutory authority, there is no legal conflict of interest for District Board members who also serve as Association Board members to participate in decisions on electric revenues that could allow the cost of water delivery to be reduced. Moreover, under the law, it is the District's responsibility to reduce water and power costs, and the Association functions exclusively as the District's agent in accomplishing certain water functions. Thus, the District is the real party in interest, the economic substance of the water support

payments does not affect the Association, and there is no legal conflict of interest.

The Customer Choice Committee further finds that the Board's stranded cost determination does not present a conflict of interest. A.R.S. §30-805(A)(3) limits the recovery of stranded costs to the unmitigated stranded costs of electric generation service. It does not contain a provision that imposes an absolute duty on public power entities to undertake mitigation efforts, as Consumers Council presumes. Absent a statutory duty to mitigate stranded costs, the Board's decision against using the payment of water support as an offset stranded costs does not give rise to a conflict of interest or constitute an unlawful act.

In the alternative, the Customer Choice Committee finds that the implied intent of the Act is for SRP to take reasonable operational steps to mitigate the level of stranded costs. The Act, however, does not require that SRP place its operations in financial jeopardy or abstain from other statutory responsibilities, such as provision of water support. Thus, again, the Board's decision against using the payment of water support as an offset stranded costs does not give rise to a conflict of interest or constitute an unlawful act.

More importantly, whether or not the Act imposes a duty to mitigate stranded costs, it does not require that stranded generation costs be mitigated or reduced with funds from sources that are unrelated to generation service. Since the funds used to support water delivery are not a cost of electric generation service and do not increase the cost to generate electricity, the elimination of those funds from electric revenues will not reduce or mitigate SRP's stranded generation costs. As a result, there is no conflict of interest for dual Board members to determine stranded costs.

The Customer Choice Committee also finds that the Board's return on capital determination does not present a conflict of interest. As discussed by Management, SRP is entitled to earn a return on capital and to use those earnings for authorized purposes. Under A.R.S. §48-2303(A)(6), the use of electric revenues to support water operations is an authorized purpose. As a result, there is no conflict of interest for dual Board members to determine the return on capital.

2. Water Support

Consumers Council alleges that the Board's decision to offset stranded costs by one-half of the water subsidy lacks evidentiary basis and further demonstrates the conflict of interest that exists for members who serve on both the District and Association Boards. (Consumers Council Application for Rehearing on Terms and Conditions, para. 2).

Consumers Council's allegation is factually incorrect. The stranded cost determination contained in the December 7th Resolutions did not offset stranded costs by one-half of the water subsidy. The Customer Choice Committee in its Revised Final Report and Recommendations to the Board, dated August 14, 1998, at pages 68-69, had recommended that Management's revised stranded cost calculation be reduced by an equivalent to one-half of generation-related water support, but that recommendation was not adopted by the Board. The Board instead adopted the joint recommendation on stranded cost recovery that was proposed at the August 14, 1998 Board meeting by Management, the large general service customers, and RUCO. That proposal calculates stranded costs using a different methodology and caps stranded cost recovery at \$795 million. It does not include an offset to stranded costs for water

support. Since the December 7th Resolutions did not adopt the claimed offset, the Consumers Council's allegation is factually incorrect and should be rejected.

B. DUE PROCESS

The United States and Arizona constitutions protect the right of due process. U.S. Constitution, Amendment XIV, provides that "No State shall . . . deprive any person of life liberty, or property, without due process of law." Arizona Constitution Article 2, Section 4, provides that "No person shall be deprived of life, liberty, or property, without due process of law. Consumers Council alleges that its constitutional due process rights have been violated by the manner in which SRP noticed and conducted the competition and pricing proceedings.

1. Adequacy of Time in the Competition Proceedings

Consumers Council claims that SRP provided only three weeks notice to customers of the stranded cost proceeding, and less with respect to other issues. Consumers Council argues that, as a matter of law and fact, the notice provided an insufficient period of time in which to prepare for such a proceeding and deprived Consumers Council of its federal and state constitutional due process rights. Consumers Council argues that the grant of rehearing by the Board does not cure the defect because, prior to rehearing, SRP had executed a settlement agreement with some of the parties to the competition proceedings regarding stranded cost recovery. (Consumers Council Application for Rehearing on Terms and Conditions, para. 3).

In response, Management asserts that the competition proceedings were legislative in nature and were conducted in accordance with the public process established in A.R.S. §30-802(B). Management contends that the legislatively required

procedures for notice and participation were met and that the Consumers Council therefore, by definition, received due process. Nothing more is required. Further, Management asserts that the competition proceedings spanned four months and presented multiple opportunities during that period for Consumers Council to submit any arguments or evidence.

Management also points out that Consumers Council is factually incorrect that SRP entered into a settlement agreement on stranded cost recovery. Management and several participants in the competition proceedings developed a joint recommendation on stranded cost recovery and presented it for consideration by the Board. The Board was free to accept that joint recommendation or a proposal from another participant. (Management Brief, pp. 16-17).

The Customer Choice Committee finds that the December 7th Resolutions properly determined that SRP provided adequate notice of the competition proceedings and that Consumer Council's due process rights were not violated. The law makes an important distinction between adjudicative proceedings and legislative proceedings for the purpose of determining what process is due under the constitutional protections. There is no question that SRP's competition proceedings were legislative in nature. The subject matter of the proceedings was the adoption of terms and conditions to govern the provision of competitive electric services within SRP's service territory, not the adjudication of a particular party's interests.

As legislative proceedings, there is no constitutional right to a hearing for a specific individual. J. Nowack, R. Rotunda, and N. Young in *Constitutional Law* (2d ed. 1983). Under Arizona law, due process requires only that in legislative proceedings all

interested parties be allowed to present their views and arguments. *Hart v. Bayless Investment & Trading Company*, 86 Ariz. 379, 389, 346 P. 2d 1101, 1108 (1959). See also *Rosenberg v. Arizona Board of Regents*, 118 Ariz. 489, 492, 578 P.2d 168, 171 (1978); *Croff v. Evans*, 130 Ariz. 353, 356, 636 P.2d 131, 134 (App. 1981).

The legislature prescribed the process to be followed in SRP's competition proceedings. A.R.S. §30-802(B) sets forth requirements for notice, the availability to the public of pertinent information, the acceptance of written comments, and the conduct of a meeting to afford Management the opportunity to explain its proposed terms and conditions, any consultants the opportunity to comment, and interested persons a reasonable opportunity to submit written comments and questions or make oral presentations of views, comments, and questions. Pursuant to A.R.S. §30-802(B), SRP provided multiple notices of its proceedings, conducted a series of meetings to obtain public comments and input, provided numerous opportunities for interested persons to submit written comments, and provided a room full of pertinent information. The details of this process are described in the Customer Choice Committee's Revised Report and Recommendations, pages 2-7. In each aspect of the process, SRP met or exceeded the requirements of the A.R.S. §30-802(B). SRP has, therefore, provided the due process required.

Furthermore, the Customer Choice Committee finds that, not only did SRP meet the statutory notice requirement, it provided extensive opportunity for interested persons to submit oral and written comments on the terms and conditions for competition. As discussed by Management, the competition proceedings occurred over the four-month period from April 13 to August 14, 1998, when the Board adopted the first Resolution on

the terms and conditions. The Board then granted rehearing on the August 14th Resolution and reopened consideration of all of the terms and conditions in conjunction with the pricing proceeding. The rehearing and reconsideration each provided additional opportunities for interested persons to submit comments that extended to December 7, 1998, when the Board adopted the December 7th Resolutions. As a consequence, the Consumers Council had nearly an eight-month period, from April 13 to December 7, 1998 to prepare and submit comments and evidence on the terms and conditions. If Consumers Council did not avail itself of the opportunity to prepare and fully present its position to the Board during that eight-month period, it must have chosen not to do so. It had adequate time to prepare.

Similarly, if Consumers Council did not avail itself of the opportunity to prepare and fully present its position to the Board after August 14, 1998, it did so by choice. It was not precluded from doing so by a "settlement agreement". As previously discussed, there was no settlement agreement. Management, the large industrial customers, and RUCO submitted a joint recommendation to the Board on stranded cost recovery. The Board was not party to the proposal, was not bound by the proposal, and was free to exercise its discretion to either accept or reject the parties' recommendation. The Board's adoption of that proposal did not foreclose Consumers Council from advocating a different stranded cost recovery approach. Further, the fact that the Board reopened consideration of all of the terms and conditions, including the stranded cost calculation, contravenes Consumers Council's argument.

We recommend that Consumers Council's allegation of denial of due process be rejected.

2. Adequacy of Time in the Pricing Proceeding

Consumers Council claims that Management's pricing proposal was not available until October 5, 1998 and that the last meaningful opportunity to comment on the proposal was November 16, 1998. Consumers Council argues that, as a matter of law and fact, this was an insufficient period of time in which to prepare for such a proceeding and deprived Consumers Council of its federal and state constitutional due process rights. (Consumers Council Application for Rehearing on Pricing, para. 6).

Management asserts that its general discussion of due process with respect to the competition proceedings also applies to this issue and that SRP's pricing proceeding met and exceeded the due process required in a legislative proceeding.

In addition, Management highlights the timeframe that governed scheduling of the pricing proceeding. As explained by Management, the Act was enacted by the legislature in late May 1998 and did not become effective until August 21, 1998. It mandates that SRP adopt terms and conditions for competition, unbundle its prices, and commence competition no later than December 31, 1998. Since the provisions of the terms and conditions affect prices and the pricing structure, the competition proceedings were conducted before the pricing proceeding. SRP began the competition proceedings prior to the effective date of the Act in order to allow as much time for the process as possible. The Board adopted terms and conditions on August 14, 1998, which included the joint recommendation on stranded cost recovery. Since that joint recommendation provided for a stranded cost recovery approach substantially different from that Management had proposed, it was necessary for Management to completely redo its pricing proposal, which was then published on October 5, 1998. Management

conducted a series of public meetings on its pricing proposal and the Board undertook consideration of the pricing issues at its November 9 and 30 and December 7, 1998 Board meetings.

Management contends that Consumers Council has been aware since the Act was passed in May 1998 that a pricing proceeding would take place, what the basic structure and purpose of the proceeding would be, and that unbundled prices must be adopted prior to the commencement of competition. Management states that Consumers Council was afforded a period of 63 days, from October 5, 1998 to December 7, 1998, to prepare and present its comments and evidence on pricing issues. Management contends that Consumers Council received adequate time to prepare and was not denied due process. (Management Brief, pp. 28-30).

The Customer Choice Committee finds that SRP provided adequate time for Consumers Council to prepare for the pricing proceeding and that its constitutional due process rights were not violated. Consistent with our discussion of due process in Section V(B)(1) of this report, which is incorporated into this discussion by reference, SRP's pricing proceeding was legislative in nature, and it met or exceeded applicable statutory requirements. SRP has, therefore, provided the due process required. The Customer Choice Committee further finds that SRP afforded interested persons sufficient opportunity to prepare and present comments and evidence on pricing matters, particularly given the timeframe imposed by the Act for conducting the competition and pricing proceedings and implementing competition. The Customer Choice Committee recommends that the Board reject Consumers Council's allegation that it was denied due process.

3. Conduct of the Competition and Pricing Proceedings

The Consumers Council alleges that the manner in which the competition and pricing proceedings were conducted violated its federal and state constitutional due process rights. The Consumers Council contends that it was denied the rights to discovery, cross-examination, and any other meaningful way of testing the assertions of Management and other parties. (Consumers Council Application for Rehearing on Terms and Conditions, para. 4, and Application for Rehearing on Pricing, para. 7).

In response, Management reiterates its position that the competition and pricing proceedings were legislative in nature and accorded the due process necessary by meeting or exceeding the requirements of the Act. Management contends that, although the Act does not mandate the conduct of discovery or cross-examination, SRP provided interested persons comparable opportunities to submit written questions and to question representatives of Management. According to Management, Consumers Council participated in both of these activities. (Management Brief, pp. 17-18).

The Customer Choice Committee finds that the conduct of the competition and pricing proceedings did not violate Consumers Council's due process rights. Consistent with our discussion of due process in Section V(B)(1) of this report, which is incorporated into this discussion by reference, SRP's competition and pricing proceedings were legislative in nature, and met or exceeded applicable statutory requirements. SRP has, therefore, provided the due process required. What the Consumers Council seeks is the type of discovery and cross-examination conducted in adjudicative trials or hearings. Those procedures, however, are not required by the law for legislative proceedings or specifically by A.R.S. §30-802(B) for SRP's competition

proceedings. The Customer Choice Committee accordingly recommends that Consumers Council's Applications for Rehearing on this issue be rejected.

4. Evidentiary Record

In both of its Applications for Rehearing, the Consumers Council argues that, absent testimony under oath, cross-examination, and discovery through depositions, there is no evidence of any kind in the record of the competition and pricing proceedings and no evidence to support any of the findings or decisions of the Board. (Consumers Council Application for Rehearing on Terms and Conditions, para. 5, and Application for Rehearing on Pricing, para. 8).

Management again relies on its position that the competition and pricing proceedings were legislative in nature and accorded the due process necessary by meeting or exceeding the requirements of the Act. (Management Brief, p. 18).

The Customer Choice Committee finds that the Consumers Council's argument is erroneous. Arizona courts have held that "the failure to administer an oath to witnesses will not vitiate an administrative proceeding unless a statute requires the administering of the oath." *East Camelback Homeowners Association v. Arizona Foundation for Neurology and Psychiatry*, 18 Ariz, 121, 128, 500 P.2d 906, 913 (App. 1972). Here, neither A.R.S. §30-802(B) on the process for competition proceedings, nor any other statutory provision, requires that Management, consultants, or interested persons present testimony under oath. SRP's competition and pricing proceedings were legislative in nature and the comments and arguments that were presented in those proceedings by Management and interested persons constitute evidence and became part of the evidentiary record even though not they were not sworn statements.

As a result, contrary to the position of the Consumers Council, there is evidence in the record to support the findings and decisions made by the Board.

C. CONSTITUTIONALITY OF THE ACT

1. Vagueness

The Consumers Council asserts that, as a matter of fact and law, SRP is not entitled to recover stranded costs and that the Act, to the extent it purports to allow such recovery, is void for vagueness in its failure to define the term "stranded costs". The Consumers Council offered no explanation or legal argument in support its assertion. (Consumers Council Application for Rehearing on Terms and Conditions, para. 8).

Management disagrees that the Act is unconstitutionally vague. According to Management, A.R.S. §30-805(A)(3) does define stranded costs as being:

. . . incurred as a direct result of competition among electricity suppliers, that were incurred by public power entities to serve their customers in this state before December 26, 1996 and that may not be recoverable in a competitive electric generation service market. Unmitigated stranded costs may include employee severance costs necessitated by electric competition including unemployment compensation, training and severance benefits.

In further support of its position, Management relies on the discussion of sufficient certainty in *Connally v. General Construction Co.*, 269 U.S. 385, 391-392, 46 S. Ct. 126, 127-128 (1926). In that case, the United States Supreme Court held that statutes are sufficiently certain when:

they employed words or phrases having a technical or other special meaning, well enough known to enable those within their reach to correctly apply them, or a well-settled common-law meaning, notwithstanding an element of degree in the definition as to which estimates might differ, or . . . that, for reasons found to result either from the text of the statutes involved or the subjects with which they dealt, a standard of some sort was afforded.

Management additionally relies upon *Village of Hoffman Estates v. Flipside, Hoffman*

Estates, Inc., 455 U.S. 489, 498-99, 102 S. Ct. 1186, 1193 (1982) for the proposition that “[t]he degree of vagueness the Constitution tolerates” depends on such factors as whether the statute defines criminal conduct or is merely economic regulation. Based on this case law, Management contends that, although the Act does not specifically include "stranded costs" in its definition section, the term has a technical or special meaning and that meaning is well enough known to enable compliance with the legislation. Management further contends that, since the Act is merely economic regulation, and is unrelated to criminal law, the stranded cost provision is not unconstitutionally vague.

The Customer Choice Committee finds that Consumer Council's assertion should be rejected on four grounds. First, it is vague, unexplained, and lacks evidentiary or legal support. Second, it includes no new argument or evidence that persuades us that the Board's rejection of the same assertion in the December 7th Resolutions was improper. Third, it is incorrect that the Act does not define stranded costs. A.R.S. §30-805(A)(3) defines that stranded costs that public power entities may recover. Fourth, it lacks legal basis. Setting aside the definition of stranded costs in A.R.S. §30-805(A)(3), "stranded costs" is a term with technical and special meaning in the national restructuring of the electric utility industry and, under the law, the use of that term in the Act provides sufficient certainty in the legislation. The Customer Choice Committee finds that the Act is constitutional and does provide legal basis for SRP to recover stranded costs.

2. Special Law

Consumers Council asserts that the Act does not provide a legal basis for SRP to

conduct the competition proceeding or to recover stranded costs because the Act is an unconstitutional special law. The Consumers Council again failed to offer any explanation or legal argument in support of its assertion. (Consumers Council Application for Rehearing on Terms and Conditions, para. 9).

In response, Management cites to 20 circumstances enumerated in the Arizona Constitution, at Article IV, Part 2, §19, for which no local or special laws may be enacted. Without specificity in Consumers Council's Application for Rehearing on Terms and Conditions, Management assumes that Consumers Council is relying on the constitutional prohibition against special laws "granting to any corporation, association, or individual, any special or exclusive privileges, immunities, or franchises." Based on this assumption, Management argues that the Act does not fit within the prohibition because it applies to all public power entities. Management contends that although there are "few" public power entities within the meaning of the Act, the Act is not unlawful special legislation. In support of this contention, Management cites to *Arizona Downs v. Arizona Horsemen's Foundation*, 130 Ariz. 550, 557-58, 637 P.2d 1053, 1060-61 (1981)("Arizona Downs"), which holds that:

A law is general, and thus permissible, if it confers rights and privileges or imposes restrictions upon all members of a given class, when the classification has a reasonable basis. A special law applies only to certain members of a class or to an arbitrarily defined class which is not rationally related to a legitimate legislative purpose. . . . But a law is not special simply because it may have only a limited application. Such a law will be general if it applies to all cases and to all members of the specified class to which the law is made applicable.

(Management Brief, pp. 21-23).

The Customer Choice Committee finds that Consumer Council's assertion should be rejected on three grounds. First, it is vague, unexplained, and lacks evidentiary or

legal support. Second, it includes no new argument or evidence that persuades us that the Board's rejection of the same assertion in the December 7th Resolutions was improper. Third, it is incorrect that the Act is an unconstitutional special law. Consistent with the requirements articulated in *Arizona Downs*, the Act reasonably classifies public power entities as a class and applies to all members of that class. Since the Act is not an unconstitutional special law, it does provide a legal basis for SRP to conduct the competition proceeding and to recover stranded costs.

D. STRANDED COSTS

1. The Twelve Stranded Cost Factors

Consumers Council alleges that there is no evidence in the record to support the Board's conclusion that its decision on stranded costs considered the 12 factors enumerated in A.R.S. §30-805(A)(3). (Consumers Council Application for Rehearing on Terms and Conditions, para. 7).

Management disagrees. Management states that it presented substantial evidence on each of the 12 stranded cost factors during the competition proceedings and that the Board's August 14th Resolution discusses each factor. (Management Brief, pp. 19-20).

The Customer Choice Committee finds that Consumer Council's allegation should be rejected. It fails to present any new argument or evidence that persuades us that the Board's rejection of the same allegation in the December 7th Resolutions was in error. It also is contrary to fact. The Board's stranded cost recovery determination did include consideration of the 12 factors enumerated in A.R.S. §30-805(A)(3).

Evidence on the stranded cost factors is contained in the record in the August 14, 1998 transcript, pp. 45-55, Management's October 21, 1998 presentation, and the October 21, 1998 transcript, pp. 50-57. Moreover, the Board discussed the stranded cost factors at length in Section 6 of the August 14th Resolution, as well as in the Rehearing Resolution and the Revised Terms and Conditions Resolution. The Customer Choice Committee accordingly recommends that the Board again reject Consumers Council's allegation.

2. Evidentiary Support

The Consumers Council claims that there is no evidence to support the level of stranded costs approved for recovery or the methodology utilized for stranded cost recovery in the December 7th Resolutions. Consumers Council contends that, to the extent the methodology allows for the recovery of stranded costs that have not actually been incurred as a direct result of competition, the methodology violates A.R.S. §30-805(A)(3) and is unlawful. (Consumers Council Application for Rehearing on Terms and Conditions, para. 6).

Management defends the evidentiary basis for the stranded cost determination contained in the December 7th Resolutions. Management asserts that, during the competition proceedings, and particularly at the October 21, 1998 rehearing, it presented substantial evidence on SRP's total estimated stranded costs of \$1.08 billion. As noted by Management, the Board approved stranded cost recovery of only \$795 million, which is well below the level justified by the evidence. Management also asserts that the competition proceedings were legislature in nature and that the

comments and arguments presented by Management and interested parties represent evidence even though not they were not given under oath. See *East Camelback Homeowners Association v. Arizona Foundation for Neurology and Psychiatry*, 18 Ariz, 121, 128, 500 P.2d 906, 913 (App. 1972). (Management Brief, pp. 18-19)

The Customer Choice Committee finds that the Consumers Council's argument is erroneous. Consistent with our discussion in Section V(B)(4) of this report, which is incorporated into this discussion by reference, the Customer Choice Committee finds that the competition proceedings were legislative in nature and, as such, did not require the taking of testimony under oath and subject to cross-examination as in adjudicative proceedings. The presentations and comments made by Management and the oral and written comments submitted by interested persons during the competition proceedings constitute evidence and became part of the evidentiary record upon which the Board lawfully based its stranded cost decision. That evidence supports the level of stranded costs approved for recovery and the methodology utilized for stranded cost recovery in the December 7th Resolutions. The presentations made by Management and the comments offered by interested persons at the August 14, 1998 Board meeting and the October 21, 1998 rehearing proceeding specifically addressed those matters. There is evidence in the record to support the stranded cost determination contained in the December 7th Resolutions, and Consumers Council's argument to the contrary should be rejected.

The portion of the Consumers Council's allegation pertaining to the lawfulness of the stranded cost methodology approved by the Board will be discussed with a similar allegation in Section V(E)(4) of this report.

3. Mitigation by Water Support

In its Application for Rehearing on Terms and Conditions, Consumers Council alleges that SRP acknowledges, and the Act confirms, that SRP has a duty to mitigate stranded costs. SRP failed to fulfill this duty, according to Consumers Council, because it did not prohibit payment by the District to the Association of funds to subsidize the cost of water. (Consumers Council Application for Rehearing on Terms and Conditions, para. 10).

In response, Management references the arguments it presented on the conflict of interest issue to the effect that the elimination of water support is not an element of mitigation and that it is proper for SRP to earn a return on its capital devoted to providing electric service and to use the earned return to support other authorized activities. (Management Brief, p. 23).

The Customer Choice Committee finds that the allegations made by Consumers Council are once again incorrect. SRP has not acknowledged that A.R.S. §30-805(A)(3) imposes a duty to mitigate stranded costs. To the contrary, the Customer Choice Committee in its report on rehearing of the August 14th Resolution, which was adopted by the Board in the Rehearing Resolution, found that A.R.S. §30-805(A)(3) limits the recovery of stranded costs to those costs that are unmitigated, but does not contain a provision that expressly requires public power entities to undertake mitigation efforts. We reach that same finding in this report.

Consistent with our discussion in Section V(A)(1) of this report, which is incorporated into this discussion by reference, the Customer Choice Committee finds as follows. A.R.S. §30-805(A)(3) does not contain a provision that imposes an absolute

duty on public power entities to undertake mitigation efforts. Absent such a statutory duty to mitigate stranded costs, the Board's decision against using the payment of water support as an offset stranded costs does not violate A.R.S. §30-805(A)(3).²

In the alternative, the Customer Choice Committee finds that the implied intent of the Act is for SRP to take reasonable operational steps to mitigate the level of stranded costs, but it does not require that SRP place its operations in financial jeopardy or abstain from other statutory responsibilities, such as provision of water support. As a result, the Board's decision against using the payment of water support as an offset stranded costs is not unlawful.

Whether or not the A.R.S. §30-805(A)(3) imposes a duty to mitigate stranded costs, the Customer Choice Committee finds that it does not require that stranded generation costs be mitigated or reduced with funds from sources that are unrelated to generation service, such as the funds used to support water delivery. Thus, the Board's decision against using the payment of water support as an offset stranded costs is not unlawful.

In addition, consistent with our discussion in Section V(A)(1) of this report, which is incorporated into this discussion by reference, SRP is entitled to earn a return on capital and to use those earnings for authorized purposes. See McQuillan, *The Law of*

² The findings of the Board and the Customer Choice Committee that A.R.S. §30-805(A)(3) does not impose a duty to mitigate stranded costs or to use the payment of water support as an offset to stranded costs represent an interpretation of provisions of that statute and are not intended to be, nor should be construed as, a rejection of mitigation in principle. Although no statutory duty exists for SRP to mitigate its stranded costs, the record establishes that SRP has undertaken extensive mitigation efforts. Further, the December 7th Resolutions allow recovery of a maximum \$795 million of stranded costs rather than the SRP's total estimated unmitigated stranded costs of \$1.08 billion.

Municipal Corporations, Section 35. 37.20. Under A.R.S. §48-2303(A)(6), the use of electric revenues to support water operations is an authorized purpose and no violation of A.R.S. §30-805(A)(3) has occurred.

For these reasons, the Customer Choice Committee recommends that the Board reject Consumers Council's allegation.

4. Mitigation by Excessive Earnings

Consumers Council alleges that SRP failed to mitigate its stranded costs by not considering or otherwise evaluating the use of excessive earnings as an offset. (Consumers Council Application for Rehearing on Terms and Conditions, para. 11).

Management maintains that, like water support payments, excessive earnings are not a concept of mitigation, particularly if the earnings are unrelated to generation service. Management further maintains that there is no evidence whatsoever that excessive earnings exist. It is Management's contention that, to the contrary, the evidence establishes that: the revenues derived from the price schedules adopted in the Pricing Resolution are just and reasonable, and will be very low considering SRP's asset base; and that SRP will recover at most \$795 million of stranded costs out of total estimated net stranded costs of \$1.08 billion. (Management Brief, pp. 23-24),

The Customer Choice Committee finds that Consumers Council's allegation lacks evidentiary support and we recommend that it be rejected by the Board. Consumers Council has declared that SRP has excessive earnings, but it did not offer any competent evidence to substantiate its claim. The record is devoid of any evidence from which a reasonable conclusion can be drawn that excessive earnings exist or what the dollar amount is of such earnings.

In addition, although this allegation does not expressly claim that SRP has an absolute duty to mitigate stranded costs through the use of excessive earnings, to the extent that the failure alleged by Consumers Council is premised on that belief, the Customer Choice Committee finds that it is without merit. Our rationale for this finding is the same as set forth in Sections V(A)(1) and V(D)(3) of this report. We incorporate those discussions into this discussion by reference.

5. Prudently Incurred Costs

On this topic, Consumers Council contends that, while the December 7th Resolutions concede that the recovery of stranded costs should be limited to prudently incurred costs and find that the costs and investment for which recovery was sought were prudently incurred, the evidence in the record does not support that finding. Consumers Council contends that it offered the only evidence in the record regarding such costs and that its evidence shows that hundreds of millions of dollars of costs associated with the Palo Verde Nuclear Generating Station ("Palo Verde") were imprudently incurred. In Consumers Council's opinion, there is no evidence in the record to support the Board's finding that the Palo Verde costs were prudently incurred. (Consumers Council Application for Rehearing on Terms and Conditions, para. 12).

Management submits that Consumers Council did not present any competent evidence that any element of SRP's investment in Palo Verde is imprudent. According to Management, Consumers Council merely attempted to incorporate into the record of the competition proceedings the entire record of the Palo Verde prudence audit conducted by the ACC, but identified no specific portion of that audit that applies to SRP nor submitted any documents or calculations.

It is Management's position that the issue of the prudence of investment involves two considerations: (1) was the plant reasonably needed to serve customers; and (2) were the costs of the plant prudently incurred. With respect to the first consideration, Management maintains that, unlike APS, SRP recognized that its near term growth projections would not be met and that it would not need its entire Palo Verde share to serve load, so SRP reduced its ownership in Palo Verde. In 1982, it sold a 5.91 percent interest to Southern California Public Power Authority for full book value and in 1986, it exchanged its 5.7 percent interest in Palo Verde at full book value with Los Angeles Department of Water and Power's 30 percent interest in Coronado Generation Station. With respect to the second consideration, Management maintains that accomplishing these sales of ownership in Palo Verde at full book value is the best evidence that SRP's investment in Palo Verde was prudently incurred. (Management Brief, p. 24.)

The Customer Choice Committee finds that this allegation by Consumers Council lacks evidentiary support. As with its allegation of excessive earnings, Consumers Council has declared that hundreds of millions of dollars of costs associated with Palo Verde were imprudently incurred, but it did not submit any competent evidence to substantiate its claim. It requested that the Board take administrative notice of the ACC's Palo Verde prudence proceeding, but the Board did not grant the request. The ACC's Palo Verde prudence proceeding is a voluminous matter that SRP was not a party to, and Consumers Council failed to identify or discuss any specific portions of that record that it believes are applicable to SRP.

The Customer Choice Committee finds that there is evidence in the record of SRP's competition proceedings to support the Board's finding that the Palo Verde costs

were prudently incurred. The evidence introduced by Management regarding SRP's sales of ownership interests in Palo Verde establishes that SRP's remaining ownership in the plant is reasonably needed to serve customers and that the costs of the plant were prudently incurred. To the extent those costs are reflected in the stranded cost determination, the inclusion is appropriate. Consumers Council's allegation to the contrary is without merit and should be rejected by the Board.

6. Notice of Stranded Cost Consideration

The Consumers Council alleges that its due process rights have been violated because the August 14th Resolution approved a specific level of stranded costs, but the notice SRP provided of the competition proceedings did not state that a specific level of stranded costs would be identified for recovery. Consumers Council contends that this defect was not cured by the Board's grant of rehearing on the matter because, prior to rehearing, SRP executed a settlement agreement with some of the parties to the competition proceedings regarding the specific amount of stranded costs to be recovered. Consumers Council contends that the identification of a specific amount of stranded costs should have instead been made in a rate proceeding. (Consumers Council Application for Rehearing on Terms and Conditions, para. 13).

Management asserts that the point made by Consumers Council is simply incorrect. According to Management, the Board's determination of stranded costs was made in a rate proceeding. On October 5, 1998, the Board established two public processes, which were conducted simultaneously -- one to reconsider all of the terms and conditions for competition, including the recovery of stranded costs, and the other to unbundled prices and set new price levels. These matters, together with the

rehearing proceeding, culminated in the December 7th Resolutions, which included a decision on the level of stranded cost recovery and a determination on the allocation of stranded costs among customers and customer classes. (Management Brief, p. 25).

The Customer Choice Committee finds that Consumers Council's allegation is without merit and should be rejected for five reasons. First, Consumers Council has presented no new argument or evidence that persuades us that the Board's rejection of a similar allegation in the Rehearing Resolution was in error. Second, we find that, contrary to the allegation, no due process violation has occurred. SRP's legal notice of the competition proceedings indicated, *inter alia*, that the Board would consider terms and conditions for stranded costs. The Board's decision to identify a specific amount of stranded costs and to approve a methodology to recover that amount clearly falls within the notice that terms and conditions for stranded costs would be considered. Third, as discussed in Section V(B)(1) of this report, which is incorporated into this discussion by reference, there was no settlement agreement. Management, the large industrial customers, and RUCO submitted a joint recommendation to the Board on stranded cost recovery. The Board's adoption of that proposal was an exercise of discretion and did not foreclose Consumers Council from advocating a different stranded cost recovery approach in the reconsideration of the terms and conditions or pricing proceedings. Fourth, Consumers Council asserts that the identification of a specific amount of stranded costs should have been made in a rate proceeding, but it offered no foundation, explanation, or legal basis in support of that position. Fifth, in accordance with Management's description of the process undertaken by SRP, the Board's determination of stranded costs was made in a rate proceeding. For these reasons, the

Customer Choice Committee recommends that the Board deny Consumers Council Application for Rehearing on this issue.

E. PRICES

1. Price Levels

Consumers Council claims that the prices established in the Pricing Resolution are excessive, unjust, and reasonable, and will continue to produce excessive earnings that are unwarranted and unjustified for a governmental entity like SRP. (Consumers Council's Application for Rehearing on Pricing, para. 1).

Management defends the earnings levels established in the Pricing Resolution. Management submits that, under well-established law, a public entity that provides service to the public, such as SRP, has the right to earn a return on the property devoted to the service and to use the earned return for authorized purposes. Management further submits that the prices set by the Board are projected to produce a return on assets of only 2.30 percent and a return on equity of only 3.39 percent in fiscal year 2000. According to Management, the record evidence clearly demonstrates that these projected returns are appropriate and below those of other public power entities.

The Customer Choice Committee finds that Consumers Council's allegation lacks evidentiary support. Consumers Council claims that the rates are excessive, unjust, and unreasonable, but it submitted no evidence or explanation to substantiate its position. Consumers Council also claims that the rates will continue to produce excessive levels of earnings, but again, it submitted no evidence or explanation to substantiate either that earnings were excessive under prior rates or will be excessive under the new prices. The evidence that is in the record refutes Consumers Council's

claims. The evidence establishes that the level of prices and earnings approved in the Pricing Resolution are reasonable and appropriate. The Customer Choice Committee, therefore, recommends that the allegation of Consumers Council be rejected.

2. Return on Capital

Consumers Council contends that inclusion of a return on capital in the prices approved in the Pricing Resolution is unlawful because the return is comparable to that for investor-owned utilities and because SRP is not entitled to any return on capital, much less capital provided by customers. Alternatively, Consumers Council contends that, even if SRP is lawfully able to charge some return on capital, it is unreasonable to charge a return comparable to investor-owned utilities and that there is no substantial evidence to support such a return in this proceeding. Finally, Consumers Council contends that there is no lawful or factual basis for SRP to determine rates at a level that will allow it to profit from the provision of electric service. (Consumers Council Application for Rehearing on Pricing, para. 2).

In response, Management reasserts its argument that a public entity such as SRP has a right to recover a reasonable return on the capital invested in providing service to customers and to use the earnings for any lawful purpose. This right entitles SRP to a return that is comparable to the return for investor-owned utilities. The return provided in the Pricing Resolution is, according to Management, well within the range of return earned by other public power entities. (Management Brief, pp. 26-27).

The Customer Choice Committee finds that, contrary to Consumers Council's allegations, the prices established in the Pricing Resolution lawfully include a return on capital. The right of public entities such as SRP to earn a return on capital devoted to

public service was discussed in Sections V(A)(1) and V(D)(3) of this report. We will not repeat those discussions here, but incorporate them into this discussion by reference.

With regard to the levels of return on capital provided in the Pricing Resolution, the Customer Choice Committee finds that the projected return on assets of 2.30 percent and return on equity of 3.39 percent for fiscal year 2000 are reasonable and appropriate. Consumers Council is incorrect that there is no substantial evidence to support these returns. The pricing proposal submitted by Management and Management's presentations at the Board meetings on November 9 and 30 and December 7, 1998 constitute the requisite evidentiary support.

With regard to Consumers Council's claim that the returns approved by the Board are comparable to those for investor-owned utilities, the Customer Choice Committee finds that the allegation is unproven. Consumers Council proffered no cost of capital determinations by the ACC for comparison to the levels of return included in SRP's prices. The Customer Choice Committee would be quite surprised if any returns authorized by the ACC for electric utilities of comparable size to SRP are as low as the 2.30 and 3.39 percent returns inherent in SRP's prices.

In accordance with this discussion, the Customer Choice Committee finds that Consumers Council's allegations are without merit and we recommend that they be rejected by the Board.

3. Lawfulness of Return on Capital Under the Act

Consumers Council argues that the prices approved by the Board violate A.R.S. §30-805(A)(1), which requires SRP to establish prices and terms and conditions that reflect the just and reasonable price for providing the service. It is Consumers Council's

position that the prices set in the Pricing Resolution violate that provision by including a return on capital that is comparable to that charged by investor-owned utilities and by allowing for the generation of revenues sufficient to fully subsidize the cost of providing water to customers of the Association. (Consumers Council Application for Rehearing on Pricing, para. 3).

Management on brief again responds to Consumers Council with the argument that a public entity such as SRP has a right to recover a reasonable return on the capital invested in providing service to customers. This right entitles SRP to a return that is comparable to the return for investor-owned utilities and to use the return for any authorized purpose, including support of water service. The return provided in the Pricing Resolution is, according to Management, well within the range of return earned by other public power entities. (Management Brief, p. 27).

The Customer Choice Committee finds that, contrary to Consumers Council's allegations, the prices established in the Pricing Resolution lawfully include a return on capital. Public entities such as SRP have a right to earn a return on capital devoted to public service and to use those earnings for other authorized purposes, as discussed in Sections V(A)(1) and V(D)(3) of this report and incorporated into this discussion by reference. Given the right for SRP to earn a return, the inclusion of a return on capital in SRP's prices does not violate A.R.S. §30-805(A)(1). Similarly, given the right for SRP to use its earnings for other authorized purposes, the use of the funds to provide support for water service in accordance with A.R.S. §48-2303(A)(6) does not violate A.R.S. §30-805(A)(1). The Customer Choice Committee accordingly recommends that the Board reject Consumers Council's allegations.

4. Recovery of Stranded Costs

A.R.S. §30-805(A)(3) authorizes SRP to “establish a temporary surcharge to pay for all or a portion of the unmitigated stranded costs of electric generation service, if any, that were incurred as a direct result of competition among electricity suppliers. . . .” In its Applications for Rehearing, Consumers Council alleges that there is no substantial evidence that SRP will incur any costs as a direct result of competition among electricity suppliers, much less the \$795 million of stranded costs the Board approved for recovery. Consumers Council, therefore, contends that the stranded cost recovery methodology and the inclusion of stranded costs in the prices approved in the December 7th Resolutions are unlawful under A.R.S. §30-805(A)(3) because they allow for the recovery of stranded costs even though such costs may not actually be incurred. (Consumers Council Application for Rehearing on Terms and Conditions, para. 6, and Application for Rehearing on Pricing, para. 5).

Management in response advances the argument that the Act requires SRP to unbundle its rates and that, as a consequence of unbundling, the energy portion of its service is now based on the market price for energy, which gives rise to stranded costs (Management Brief, p. 28).

The Customer Choice Committee finds that the record is replete with evidence that SRP will incur stranded costs as a direct result of competition. Further, we find that, as a result of the rate unbundling mandated by the Act, SRP must price the energy portion of its electric service not based on traditional costs, but at the price of the competitive market in order to be an effective competitor. This pricing gives rise to stranded costs within the meaning of A.R.S. §30-805(A)(3). Consumers Council's

allegations are inconsistent with these findings and should not be adopted.

VI. CONCLUSION

The Customer Choice Committee has arrived at the findings and recommendations set forth in this report based on review and careful consideration of the entire record. We reserve the right to modify and supplement this report, and will consider any comments received from the applicants for rehearing, Management, and the public. The Customer Choice Committee recommends that the Board adopt the findings and recommendations set forth in this report.