

SRP Management Comments on the Revised Customer Choice Committee Report March 29, 1999

SRP Management supports the Revised Customer Choice Committee Report, and recommends its adoption to the Board. SRP Management suggests these additional items for consideration by the Board and for inclusion in the final resolution.

1. The report and the record should be amended to reflect the final determination by the United States Department of the Interior on federal issues raised by Tucson Electric Power.

On March 5, 1999, the United States Department of the Interior wrote a letter to Tucson Electric Power's Washington attorney, Thomas Jensen, indicating the Department's final determination on a broad array of complaints that TEP had made about the competitive activities of SRP and New West Energy. A copy of the letter is attached. The DOI letter rejected every argument raised by TEP concluding:

Based on the information presented to the Department, this office cannot conclude that SRP has violated any provision of federal reclamation law or any provision in any existing contract between the Department of the Interior and SRP.

The findings of DOI provide further authority to reject the argument made by TEP that the United States is an indispensable party to either the terms and conditions proceeding or the pricing proceeding.

At the federal level, TEP made a number of arguments, each of which was rejected by DOI. These arguments included:

- TEP argued that competitive activities by SRP, and specifically the formation and operation of New West Energy, violated federal reclamation law.

DOI responded: "As a creature of state law, SRP may engage in any business enterprise authorized by state law, unless such activity would interfere with SRP's performance of its duties under federal law and contract as operator of the federal reclamation Project." (page 5)

- TEP argued that The United States ownership interest in SRP extends to all assets of the Association and the District, including all of SRP's

power facilities, and thus provides a basis for DOI to regulate all SRP power sales, including sales to New West Energy.

DOI responded: “Federal reclamation law does not preclude individual irrigation or agricultural improvement districts from purchasing or developing their own power facilities. In the absence of such limitations . . ., SRP has, throughout the century, engaged in an aggressive course of action to maintain, expand, diversify and maximize its power generation facilities. . . .SRP constructed or acquired most of these facilities in the period since SRP fully repaid the Project’s original construction debt. Since that time, SRP has operated and distributed the power from its facilities without federal participation.” (page 8 – 9)

- TEP argued that the interest of the United States in the reclamation functions of SRP mandates that the United States must regulate SRP, because any time SRP makes a sale of power it is “converting a publicly owned asset into private hands”.

DOI responded: “The United States has an interest in the property of the Project. TEP also points out contractual provisions that provide a basis for additional regulatory oversight by the United States. It does not follow from the United States’ interest in the Project, however, that the U.S. must regulate SRP or that SRP is selling federal power any time it engages in any power sales.” (page 7 – 8)

- TEP argued that the federal interest in the original facilities of SRP means that power from any SRP facility should be considered “federal power” or that all SRP power sales are subject to federal regulation.

DOI responded: “We disagree. [1917 Contract] was intended to address modifications to dams, canals and aqueducts and other facilities, and cannot fairly be extended to address power sales from SRP facilities.”

- TEP argued that SRP was in violation of federal tax law because SRP uses “power profits” in part to support water delivery.

DOI responded that support of water delivery is “contemplated” by tax law. DOI pointed out that federal restrictions on the use of revenue apply to the “hydropower facilities” of SRP, and not to other generating facilities. (page 11 – 12)

These findings by the Department of the Interior are relevant to the arguments being made by Tucson Electric Power in these proceedings and SRP Management requests that the DOI letter be made part of the record.

In these proceedings TEP argues that the United States is an indispensable party because the United States has an obligation to oversee the activities of SRP. TEP bases this assertion on the argument that the United States has an ownership interest and oversight function in all of SRP.

In a very detailed and direct manner, the Department of the Interior has rejected the TEP assertions underlying this argument. The DOI findings provide additional support for the rejection of TEP's argument that the United States is an indispensable party to these proceedings.

2. New Developments at the Corporation Commission Further Support the Board's Decisions.

TEP has raised an issue relative to the statutory obligation of SRP and the Corporation Commission to coordinate their respective activities in transitioning to a competitive generation market. TEP has argued that this means that SRP must adopt the identical divestiture and affiliate rule provisions as are in the Corporation Commission rules.

Management previously pointed out that the Commission rules have been stayed, and it is by no means certain that the current divestiture and affiliate provisions will be in a final rule. Since that time the Commission has scheduled an open meeting for April 14 to consider the rules. There is no agenda item for the open meeting to declare an emergency. This means that any rules, if any, adopted by the Commission on April 14 will not be in effect until the Commission has complied with the requirements of the Administrative Procedures Act (A.R.S. § 41-1001 *et seq.*). Assuming the Commission follows the statutory procedure (that is, assuming that the Commission does not declare an emergency at a later date), it is likely that final rules will not be adopted for at least ninety days, to allow adequate time for publication and public comment.

SRP Management has asserted that the statute does not require that SRP's rules be identical to those of the Commission, in fact differences are contemplated and expected. In fact, on the divestiture issue, the legislature rejected the divestiture approach in favor of a function separation through a code of conduct. But, even if there were a requirement to coordinate on the divestiture issue, there still is no certainty at the Commission level that the Commission will adopt this approach.

3. Additional Discussion on the issue of whether SRP may recover stranded costs

In section V(E)(4) of the report is a discussion of the argument made by Consumers Council, that SRP may not recover stranded costs because there is

not currently competition in SRP's service territory. SRP Management requests that the Board clarify the discussion set forth in this section, as discussed below.

In its December 7 resolution the Board established cost-based generation prices for all SRP customers. This is the same type of process as the board has conducted in every price adjustment case. The only material difference is that components of total price have been broken out separately from other components of price, and that there is a separate break-out (as part of the total cost-based generation price) of "stranded costs".

The concept of stranded costs is fairly straightforward. "Stranded costs" (or "stranded benefits") are the difference between a generation price set according to traditional cost-of-service principals, and a generation price which exists in a competitive market. If the cost-of-service price is above the market price, the difference is "stranded costs". If the cost-of-service price is below the market price, the difference is "stranded benefits".

All customers are now being charged cost-based prices as approved by the Board on December 7. No customer is being charged, nor will a customer be charged, any additional amount as "stranded costs". But, the December 7 resolution set up a pricing structure which will allow the transition to competition. When a customer becomes subject to competition, the market-based portion of the generation price will become subject to competition. The remainder of the generation price, the "stranded" portion of the cost-based price, will continue as a non-bypassable charge to the customer (to be adjusted downward and phased-out as set forth in the December 7 resolutions).

As supported by the evidence presented by SRP management, if generation prices were set to recover all costs, the "stranded" portion of the generation price (assuming all customers were subject to market price competition) would total \$1.08 billion over the six years from 1999 to 2004. Through negotiations, SRP Management and customer groups agreed to reduce the total generation price by reducing the portion of the total price designated as "stranded costs". The Board adopted the joint recommendation of the customer groups and SRP Management. Thus, the reduced "stranded" portion of generation price has been capped at \$795 million over six years, calculated on a nominal basis. By reaching this agreement, the total generation price to all customers was reduced.

Thus, it can be said that if SRP set generation prices in a manner to recover total costs, then generation prices would be higher (as a nominal number over six years) by \$285 million. This is the difference between the cost based generation price (\$1.08 billion plus the market price component) and the Board-approved generation price (\$795 plus the market price component).

Thus Consumers Council's arguments are misplaced. The overall generation price reduction approved by the Board results in prices which are below total cost

of service. The fact that a portion of this price is broken out as a non-bypassable stranded cost component, in anticipation of competition, does not increase the price to any customer and is a proper component of cost-based prices.

SRP Management requests that the Board adopt this revised figure and the discussion herein in its final response to this argument by Consumers Council.

4. Even if Consumers Council's Arguments on Palo Verde Prudency are Accepted, the Result in these Proceedings Would Not Change

SRP Management requests that the Customer Choice Committee Revised Report be amended to include a discussion about the effect of the Palo Verde prudency arguments made by Consumers Council, assuming the arguments are valid. In short, the prudency issue would not effect the overall result in these proceedings.

Consumers Council has presented no evidence that any portion of SRP's investment in Palo Verde was imprudent, nor has Consumers Council presented any argument as to the effect of this argument on the overall result. SRP Management has shown that since Palo Verde construction, the Board has considered and accepted the costs of Palo Verde in its price setting processes¹.

The issue of prudency at Palo Verde is really two issues: whether the utility built too much capacity too soon, and whether the actual bricks and mortar costs were excessive. Since SRP sold its unneeded share of Palo Verde, only the second type of prudency is at issue here.

As set forth in SRP Management's presentation at rehearing, the prudency audit conducted for APS by the Corporation Commission disallowed \$60 million of the total Palo Verde costs as "imprudent"². Based on APS's total share of Palo Verde of 29.1 percent, this would be a total disallowance for APS of \$17.5 million.

For Public Service of New Mexico, another Palo Verde participant, the state commission disallowed \$10 million³ for PSNM's 10.2 percent overall share⁴.

For El Paso Electric Company, a 15.8% Palo Verde participant, the state commission disallowed \$28 million for construction imprudence⁵.

¹ SRP does not set its revenue requirement using a "rate base" as do investor owned utilities. Rate base is a concept relating to return on private investment. Rather, SRP's revenue requirement is based only on the revenue needed to maintain SRP as a healthy electric utility.

² It should be noted that APS was project manager for Palo Verde construction.

³ There was an additional disallowance because of excess capacity, not an issue for SRP because SRP sold its excess interest in Palo Verde.

⁴ Final Order, Case No. 2087, New Mexico Public Service Commission, March 6, 1990. A copy of this entire order will be placed in the Information Room and SRP Management requests that it be made part of the record in this proceeding.

For the other major Palo Verde participant, Southern California Edison, a 15.8 percent participant, no prudency review was conducted. In order to avoid the costs of a prudency review, the state Public Utilities Commission assumed that the Palo Verde investment was the same as the investment in the San Onofre Nuclear Generating Station, and adopted a stipulation to defer inclusion in rate base of certain costs from both nuclear investments⁶.

If we were to average the disallowances for APS (\$17.5 million for 29.1%), for PSNM (\$10 million for 10.2%), and for EPEC (\$28 million for 15.8%), the average disallowance, for each percent of ownership, is approximately \$1.12 million. Comparing this to the SRP ownership share of 17.5% would yield a hypothetical disallowance for SRP of \$17.4 million.

SRP's total stranded costs were shown to be \$1.08 billion. The SRP Board set stranded costs at \$795 million, a \$285 million reduction. Thus, even if this entire hypothetical amount of "imprudent" costs were deducted from the \$1.08 billion, the resulting stranded cost number would still be well above the \$795 million allowed by the Board⁷, making this a non-issue.

SRP Management requests that the Board consider these arguments in its final determination on this issue.

Conclusion

SRP Management respectfully requests that the Board adopt the Revised Customer Choice Committee report and consider the additional items set forth in these comments.

⁵ *Application of El Paso Electric Company for Authority to Change Rates*, Public Utility Commission of Texas, Docket No. 7460 (November 12, 1991), Findings 100 and 102. A copy of the entire order will be placed in the Information Room and SRP Management requests that it be made part of the record in this proceeding.

⁶ *Order Instituting Investigation into the Appropriate Cost Recovery Treatment for Cost of Power Produced at Palo Verde Nuclear Generating Station for Sale to Customers of the Southern California Edison Company*, Public Utilities Commission of California, I.85-05-001, Opinion (Decision 86-10-023 October 1, 1986), and Order Denying Rehearing (Decision 87-04-034 April 8, 1987). A copy of these orders will be placed in the Information Room and SRP Management requests that it be made part of the record in this proceeding.

⁷ Palo Verde stranded costs are a number calculated by using depreciation and operating expenses over the six year stranded cost recovery period. The issue of prudency would only effect the depreciation amount, and then only that amount during the six years. Thus, the actual stranded costs "disallowance" would be significantly lower than the total amount of the original costs.