II. Rehearing Arguments by Tucson Electric Power Company

Like the Attorney General, TEP applied for rehearing from each of the three December 7, 1998 resolutions and, like the Attorney General, raises its argument as generally applicable to the three resolutions.

TEP Argument Number One: SRP is not Entitled to Stranded Cost Recovery

SRP Management Response

TEP raises generally the same legal arguments as does the Attorney General with respect to the legal right of SRP to recover stranded costs. The arguments made above under Attorney General Argument Number One are incorporated here by reference.

TEP also contends that the Customer Choice Committee's Final Report fails to recommend terms and conditions for competition that parallel the Corporation Commission's competition rules "as required by HB 2663." Apparently, TEP believes that the legislative requirement that public power entities and the Commission coordinate their efforts means that SRP must adopt the same divestiture requirements as currently contained in the Commission's Electric Competition Rules.

If TEP's argument were correct, that the Electric Power Competition Act requires public power entities to align their rules with the Corporation Commission's rules, the Electric Power Competition Act arguably would be an unconstitutional exposure of public power entities to Corporation Commission jurisdiction. This clearly was not the legislature's intent. A "public power entity" is defined as "any municipal corporation, city, town or other political subdivision that is organized under state law, that generates, transmits, distributes or otherwise provides electricity *and that is not a public service corporation.*" A.R.S. § 30-801(16)(a). Moreover, the plain language of the Electric Power Competition Act contradicts TEP's argument. The Electric Power Competition Act creates an equal, mutual obligation, between the Corporation Commission and public power entities, to "coordinate their efforts in the transition to competition in electric generation service to promote statewide application of their *respective* rules, procedures and orders." A.R.S. § 30-802(A) (emphasis added); *see also* A.R.S. §§ 30-806, -807 (employing same language). Thus, the Electric Power Competition Act could not, and does not, grant superiority to the Corporation Commission's rules over the rules of public power entities. Indeed, the coordination requirement is itself an implicit recognition by the legislature that the rules of public power entities were likely to differ from the Corporation Commission's rules.

SRP and the Corporation Commission have taken significant steps to meet the coordination requirements of the Electric Power Competition Act. As presented at the rehearing on October 21, SRP and the Commission have been working for several years to coordinate their activities in the transition of the electric industry to competitive

markets. At the October 21 hearing SRP management (Jana Brandt) presented a summary of some of the major meetings between the Commission and SRP. This list alone shows over 400 separate meetings or other cooperative efforts involving SRP and the Corporation Commission. The meetings and efforts are still ongoing. These meetings and efforts evidence significant work to coordinate activities on virtually every subject area involved in the transition to competitive markets. Clearly both the Commission and SRP have met the statutory requirements.

TEP Argument Number Two: The December 7th Resolutions Violate A.R.S. § 30-802.A by Failing to Require that SRP Divest Itself of or Spin Off Generation Assets as a Condition to Stranded Cost Recovery.

SRP Management Response

TEP argues that SRP Board should order that SRP sell its entire generating assets, pointing to the *option* given to investor-owned utilities by the Corporation Commission.

There is no legislative requirement for divestiture, and under current state and federal law, divestiture would be difficult if not impossible. Basically, divestiture or forming a separate generation affiliate are two of a number of different approaches separate competitive and noncompetitive functions in order to insure that a distribution utility does not use its position to unfairly compete on the generation side. For public power entities, the legislature specifically rejected the divestiture or affiliate approach to separating competitive and non-competitive activities. Instead the legislature chose the "code of conduct" approach, providing for functional separation between competitive and non-competitive functions of public power entities. Specifically the Electric Power Competition Act provides in section 30-803:

> F. The governing body of a public power entity shall adopt a code of conduct to prevent anticompetitive activities that may result from the public power entity providing both competitive and noncompetitive services to retail electric customers. The code of conduct shall address at least the following issues:
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> 1. Policies for allocating costs between noncompetitive and competitive activities to avoid cross-subsidization.
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> 2. Policies to prevent employees providing noncompetitive services from directing retail electric customers to the public power entity's competitive services.
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> 3. Policies to prevent employees from transferring proprietary information gained in the performance of noncompetitive services to employees engaged in performing competitive services without the consent of the retail electric customer.

> 4. Policies to provide retail electric customers with complete and accurate disclosure of which services are competitive and which services are noncompetitive.
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> 5. Policies to prohibit preferential treatment when providing noncompetitive services based on a retail electric customer's provider of competitive services.

The legislature recognized that divestiture by public power entities would be very detrimental to customer interests. As discussed during the public process, not only would divestiture result in higher prices for customers, public power customers would also lose the advantage of a dedicated, stable generation supply.

It is important to point out here the disingenuous nature of TEP's arguments. Under a settlement agreement reached with the Commission staff in late October, 1998, TEP and the Commission agreed upon less than full divestiture for TEP. After the agreement failed to gain approval by the Commission, the Commission on January 5, 1999 stayed the application of the Commission's competition rules. It is therefor not clear whether divestiture or formation of an affiliate will be the ultimate solution chosen by the Commission.

The Board acted within the scope of its reasonable discretion in rejecting the divestiture approach.

TEP Argument Number Three: The Federal Government is an Indispensable apart to the Competition Process.

TEP contends the federal government, due to its interest in the Salt River reclamation project, is an indispensable party to the statutorily mandated process of determining the terms and conditions for retail electric competition by SRP. Indeed, TEP argues that because the United States "was not included in the development, deliberation and authorization of this matter," the Board's decision is premature. TEP's contention is incorrect.

SRP is responsible for the care, operation and maintenance of the Salt River reclamation project, including electric power facilities, by virtue of its contract with the Salt River Valley Water Users' Association ("Association"), dated March 22, 1937, as amended. The Association assumed responsibility for the care, operation and maintenance of the project as a result of its earlier contract with the United States of America, dated September 6, 1917. The contract between the United States and the Association provides in relevant part:

> [T]he United States agrees to and will as soon after the signature of this agreement, as may be practicable, turn over to and vest in the said Association, the care, operation and maintenance of the irrigations [sic] works known as the Salt River Project, . . . consisting generally of the Roosevelt Dam, the Granite Reef Dam, irrigation canals, laterals and

> ditches, and other conduits, gates, pipes, power plants, power houses, buildings and other structures of every kind, transmission, telegraph and telephone lines, wires, pumps, machinery, tools and appliances and all property of whatsoever kind, real, personal or mixed, appurtenant to or used, or constructed or otherwise acquired to be used, in connection with the said Salt River Project, wheresoever said property may be situated, and as well, all water rights and franchises, and rights to the storage, diversion and use of water for irrigation or other purposes, water power, electric power and power privileges, with such right or possession of all thereof, as shall be necessary or convenient for the care, operation and maintenance of said project by said Association, as hereinafter provided. And said Association shall from the time of the taking over of the care operation and maintenance of said project thenceforward have and receive to its own use and benefit, all the rents, issues, profits, revenue and income, including all income from power and power privileges growing out of or arising from the operation and maintenance of the project and every part thereof by it.

Id. at § Second.

The 1917 Contract specifically grants to the United States the right to: (1) inspect the project when the Secretary of the Interior "shall deem it necessary to ascertain if the provisions of this agreement are being carried out and observed by the Association in the care, operation and maintenance of the project" (*id*. at § Seventh); (2) have full and free access to the Association's books and records "relating to the project and its care, operation and maintenance" (*id*. at § Twelfth); (3) make reasonable rules and regulations (*id*. at § Thirteenth); (4) give (or withhold) prior approval of any "substantial change" to any project works; (5) give (or withhold) prior approval of power contracts covering a period of more than a year[1/] (*id*. at § Eleventh); and (6) terminate the agreement under limited circumstances (*id*. at § Ninth). Otherwise, however, the right of possession and the obligation for the care, operation and maintenance of the project was broadly conveyed to the Association, including the right to "construct additional works . . . without the necessity of procuring the assent of the Secretary of the Interior of the United States." *Id*. at §§ Second and Third.

By contrast, the 1917 Contract does *not* give the United States the right (and certainly does not require the United States) to oversee SRP's consumer protection efforts, approve of electric prices or participate in any of the other issues addressed in the Public Process. Thus, contrary to TEP's contention, nothing in the 1917 Contract between the Association and the United States (or the 1937 Contract between the Association and SRP) suggests that the federal government is required to participate in, or otherwise

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[1/] The right to prior approval of power contracts was amended in 1950 to exempt retail power contracts with customers "who do not resell energy available under such contracts." *See* 1950 Agreement attached hereto as Exhibit C, & 6. The Department of the Interior later waived the approval requirement altogether in 1972. *See* Letter dated June 14, 1972, attached hereto as Exhibit D.

ratify, the terms and conditions under which SRP operates its electric power business. The United States did not do so during the eighty years prior to the advent of retail competition; it is not required to do so now.