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Members of the Arizona Legislature

The Honorable Janet Napolitano, Governor

Dean Miller, Interim Executive Director
Arizona Corporation Commission

Transmitted herewith is a report of the Auditor General, a Review of Arizona Revised Statutes (A.R.S.) §§30-806(I), and 40-202(B)(3) and (5) related to electric competition. This report was prepared pursuant to A.R.S. §§30-806(J) and 40-202(N), and under the authority vested in the Auditor General by A.R.S. §41-1279.03.

My staff and I will be pleased to discuss or clarify items in the report.

This report will be released to the public on March 11, 2008.

Sincerely,

Debbie Davenport
Auditor General

Attachment

REVIEW

Summary

Arizona electric competition statutes require electric distribution utilities to serve as the providers of last resort in their respective service territories and allow exclusive transmission and distribution service territories. We are statutorily required to review these specific provisions and make recommendations on whether electricity suppliers should bid to be the provider of last resort. Electric competition never materialized in Arizona, but the provider of last resort provisions ensure that all consumers have access to electric services. Bidding for provider of last resort services is not currently practical because there are no competitive electric suppliers. Having exclusive transmission and distribution territories is practical to avoid duplicating infrastructure. Past actions eliminated part of Arizona's electric competition framework, and the Arizona Corporation Commission may need to revisit the framework.



2008

History and background

Nation-wide interest in electric competition developed in the 1990s, after the Federal Energy Policy Act of 1992 facilitated electric competition by lowering barriers to electric generation and increasing access to the electric transmission systems. Arizona, under the Arizona Corporation Commission (Commission), was one of 22 states that initially pursued electric competition. The Commission has exclusive authority under the Arizona Constitution to regulate Arizona public service corporations that provide electric services.¹ This authority includes determining how and if to implement electric competition.

The Commission issued electric competition rules in 1996 with subsequent revisions through 2001, laying the framework for electric competition. Under this framework, transmission and distribution services remained noncompetitive, but consumers had the option of receiving generating and meter-related services from competitive companies, referred to as electric service providers. Prior to this change, customers did not have the option of competitive providers, but received services under the traditional model where the electric distribution utility provided all electric services, called bundled services.

The Legislature enacted statutory provisions in 1998 that added to the electric competition framework and included the three provisions subject to this Auditor General review. A.R.S. §§30-806(l) and 40-202(B)(5) ensure that customers

using 100,000 kilowatt hours (kWh) or less per year will have electric generating service, and A.R.S. §40-202(B)(3) confirms the Commission's authority to allow public service corporations to have exclusive transmission and distribution service areas. In addition to reviewing these provisions, we are required to make recommendations on whether electric distribution utilities shall remain the provider of last resort or if other electricity suppliers should bid to be the provider of last resort.

Primary components of electric services

Electricity generation—Transforming mechanical motion into electricity using turbines powered by water, wind, coal, natural gas, nuclear-reaction, or other fuels.

Transmission and distribution—Moving electricity from the generation source to the end user through a network of power lines. Transmission lines move higher voltages; distribution lines supply residences and businesses at lower voltages.

Meter-related functions—

- **Metering:** Installing and programming the electric meter.
- **Meter reading:** Extracting electric usage data and transmitting it for billing or energy management purposes.
- **Billing and collecting:** Providing customers with a bill for electricity usage and other services.

¹ A public service corporation includes all corporations other than municipal corporations that furnish various public utilities, including electricity.

Competition did not materialize in Arizona and was not implemented throughout the country

Although the Commission established a competitive framework by promulgating rules and by enacting policy changes in commission orders, electric competition never materialized in Arizona. Minimal competition existed between December 1999 and March 2001, but competitive electric generation sales represented only 0.2 percent of all retail generation sales in 2000. According to utility and commission officials, competitive electric service providers left the Arizona market in March 2001 because of weaknesses in supply and demand, and suppliers could not provide electricity at lower prices than offered by the already existing utilities that historically provided

the electricity. The absence of competitive suppliers effectively suspended competition in Arizona, and all customers now receive the traditional bundled services from the distribution utilities.

Most states do not have active electric competition, and some states who began implementation have suspended those efforts. According to April 2007 U.S. Energy Information Administration (EIA) data, 28 states do not have active electric competition; 8 states, including Arizona, suspended prior restructuring efforts to implement competition; and only 14 states actively pursue electric competition.¹

Provider of last resort provisions are important safety net

A.R.S. §§30-806(I) and 40-202(B)(5) ensure that residential and small businesses will receive electric services in a competitive market. These statutes require that electric distribution utilities act as the provider of last resort for supplying electric generation services to every retail electric customer within their service territories whose annual usage is 100,000 kWh or less if other electricity suppliers are unwilling or unable to supply electric generation service and whose electric generation service has been discontinued through no fault of their own, such as if the competitive supplier goes out of business.

It appears that the 100,000 kWh cap would cover most residential and small business customers in Arizona. Auditors' analysis of 2006 EIA data found that the average Arizona residential customer used 13,250 kWh of electricity per year and the average commercial customer used 102,210 kWh of electricity per year. While the average commercial usage exceeded the 100,000 kWh cap, the category includes the whole array of commercial businesses, from small to medium and large. Thus, it appears that all residential and

many small business customers are protected by the current provisions.

Representatives from several public service corporations, public power entities, and other stakeholders that auditors interviewed agreed that electric distribution utilities should be the provider of last resort because they are typically well-established companies with distribution lines already serving customers. While bidding to determine the provider of last resort is an alternative, it is not feasible in Arizona at this time because there are no competitive electric suppliers. If robust residential competition materialized, most stakeholders who auditors interviewed said bidding is problematic because of resource planning problems when customers switch providers and the competitive suppliers' tendency to solicit only the most profitable accounts, leaving the provider of last resort to serve only more costly customers.

Some states with electric competition bid for the provider of last resort services, while others do not. Four of seven states that auditors contacted

¹ Connecticut, Delaware, Illinois, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island, and Texas.

(Delaware, Illinois, Michigan, and Ohio) reported that they have implemented provider of last resort provisions in a similar manner to Arizona, assigning the responsibility to the distribution utility. The other three states (Maine, Rhode Island, and

Texas) have bid to determine the provider of last resort and also required that transmission and distribution utilities divested themselves of all electric-generating assets.

Exclusive transmission and distribution territories are practical

A.R.S. §40-202(B)(3) restates the Commission's constitutional authority to maintain exclusive electric service territories of public service corporations and prohibits the corporations from providing distribution services in another distribution utility's territory during the transition to competition for electric generation service.

Representatives from several public service corporations, public power entities, and other stakeholders who auditors interviewed agreed that this practice was necessary because it is not economically feasible to duplicate transmission and distribution lines to the same customers.

Arizona's electric competition framework incomplete

The extent to which the three statutory provisions under review will actually come into play depends on whether Arizona's electricity market becomes competitive. The competition framework is incomplete because commission and court actions have eliminated parts of it. In 2002, the Commission stayed implementation of its rules requiring investor-owned electric distribution utilities to acquire their electric supply from the competitive electric market and requiring certain public service corporations to divest themselves of their generation assets. The Commission took this action, in part, because it deemed that the Arizona wholesale market was not workably competitive and was possibly subject to market manipulation, which could increase retail prices.

In March 2004, an Arizona Appeals Court decision further eroded Arizona's electric competition framework. This case was brought by five electric cooperatives who challenged a number of the Commission's electric competition rules. The Appeals Court voided several of the Commission's rules and found that:

- The Commission did not have the authority to require electric distribution utilities to sell their generating assets.
- The Commission did not have authority to establish an independent, state-wide energy scheduling administrator to oversee all energy transmission in Arizona.
- The Commission violated its constitutional responsibility for determining fair and reasonable rates by allowing market-based retail rates and by approving broad market rates for competitive service providers. For example, the Commission approved rates for one provider of up to \$25 per kWh, which was over 500-800 times the average electricity price at the time, which was between \$0.03 and \$0.05 per kWh.

Further, the Appeals Court invalidated all existing commission-approved electric service provider applications because the Commission had not properly evaluated the reasonableness of the providers' approved-rate schedules. However, all competitive suppliers had ceased providing services to Arizona customers 3 years before the Appeals Court ruling.

New applications may require revisiting competitive framework

Because electric competitors left Arizona in 2001 and no competitive providers had applied for certification until 2006, the Commission has not addressed the framework voided by its decision and the Appeals Court ruling.

While the Commission has so far been able to set the competitive framework aside, it may not be able to do so in the future. The Commission may need to revisit the necessity and desirability of implementing retail electric competition because of applications from competitive service providers in 2006 and the Tucson Electric Power Company's 2007 rate-increase application.

In 2006, the Commission received two competitive electric supply applications from applicants wanting to serve only a limited number of very large commercial or industrial customers. Commission staff and various electric industry stakeholders have raised several concerns about the necessity and type of electric competition that is in the public interest. Their concerns include:

- Arizona's competitive framework is incomplete;
- Competition has not reduced retail rates in states that have implemented it;
- Partial competition, as proposed in the application where competitive suppliers choose only the largest and most profitable customers, increases electricity prices for remaining customers; and
- Customers' switching back and forth among providers makes electric resource planning difficult for existing suppliers.

In 2007, the Commission's staff hired an external consultant to address the necessity and desirability of implementing retail electric competition as proposed by the first 2006 competitive electric supplier application. The consultant concluded in testimony filed with the Commission in January 2008 that approving the application would not be in the public interest and could result in increased costs to the vast majority of Arizona citizens and electricity customers. The consultant recommended that if the Commission approves the application, then it should establish a working group to identify steps to ameliorate potential adverse impacts on electricity resource planning, system reliability, inequity, rate impacts, and financial impacts on nonparticipating customers.¹ A motion to dismiss the first application was under consideration, and the Commission had not scheduled a hearing date for the second application as of March 5, 2008.

In addition, the Tucson Electric Power Company filed for a rate increase in July 2007, and its application presents three different rate-increase proposals dependent on the degree to which the Commission allows retail competition or entirely prohibits competition. Presenting these three rate-increase proposals may require the Commission to address the electric competition framework when it hears this application. The Commission has set hearing dates for this rate increase application beginning on May 12, 2008.

¹ Nonparticipating customers are those not offered services by a competitive supplier. According to the consultant's testimony, if large commercial/industrial customers switch to a competitive supplier, then rates for remaining customers may increase because the original supplier has fewer sales over which to allocate its fixed generating costs.