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ARIZONA CORPORATION COMMISSION

Brian McNeil  
Executive Director

Direct Line: (602)542-3935  
Fax: (602)542-0752  
E-Mail [wmundell@azcc.gov](mailto:wmundell@azcc.gov)

September 24, 2008

Letter to the Docket:

Re: Renewable Energy Standard and Tariff Rules (REST);  
Docket No. RE-00000C-05-0030; Decision No. 69127

Because my colleague, Commissioner Gary Pierce, decided to file an amicus brief in the special action brought by the Goldwater Institute challenging the Commission's Renewable Energy Standard and Tariff ("REST") rules, I think it is important for me to weigh in on some of the issues raised in his brief. Even though the Arizona Supreme Court declined to accept jurisdiction in the special action yesterday, the fight is not over. In today's *Arizona Republic*, the Goldwater Institute indicated that it plans file a new lawsuit in the Arizona Court of Appeals or the Maricopa County Superior Court.

When the Commission's legal staff filed the Commission's response to the special action, it expressed the Commission's position that the rules were promulgated pursuant to the Commission's exclusive, ratemaking authority found in Article 15, Section 3 of the Arizona Constitution. The response also acknowledged that some rules may be "multi-dimensional" with impacts that go beyond ratemaking to address the Commission's concerns about reliability, health, and safety. To the extent that some rules have less to do with ratemaking and more to do with health and safety, then the Commission believes that it has sufficient authority to adopt those rules under the permissive, concurrent powers also found in Article 15, Section 3 of the Arizona Constitution and pursuant to statute.

While my colleague does an excellent job of explaining the Commission's permissive and concurrent non-ratemaking authority under the Arizona Constitution, I feel compelled to contradict my colleague's assertion that the core provisions of the REST rules do not fall within the exclusive, ratemaking authority of the Commission.

The core provisions of the REST rules fall within the Commission's exclusive ratemaking powers.

As I stated in my attached December 12, 2006 letter to Attorney General Terry Goddard, R14-2-1804 and R14-2-1805 are indeed reasonably necessary to ratemaking. The Commission's constitutional ratemaking authority "extends beyond setting rates to include the promulgation of rules and regulations that are 'reasonably necessary steps in ratemaking.'"<sup>1</sup> In *Arizona Corp. Comm'n v. State ex rel. Woods*,<sup>2</sup> the Arizona Supreme Court held that the Commission has the authority to promulgate the Affiliated Interest Rules under its constitutional ratemaking power. Those rules require utilities to provide certain information to the Commission about the utility

<sup>1</sup> *Phelps Dodge Corp. v. Arizona Electric Power Co-op., Inc.*, 207 Ariz. 95, 111, 83 P.3d 573, 589 (App.2004), quoting *Arizona Corp. Comm'n v. State ex rel. Woods*, 171 Ariz. 286, 294, 830 P.2d 807, 815 (1992).

<sup>2</sup> 171 Ariz. 286, 830 P.2d 807 (1992).

and its affiliates as well as to seek the Commission's approval prior to certain transactions. The court found that the Affiliated Interest Rules "arguably prevent utilities from endangering their assets through transactions with their affiliates. If such transactions damage a utility company's assets or net worth, the company will have to seek higher rates for survival. Thus, transactions with affiliated corporations could have a direct and devastating impact on rates."<sup>3</sup> The court in *Woods* also found, "It would subvert the intent of the framers to limit the Commission's ratemaking powers so that it could do no more than raise utility rates to cure the damage from inter-company transactions."<sup>4</sup>

A utility's choice of generation assets could also have a direct and devastating impact on rates. The Commission has seen how Arizona utilities' increasing dependence on fossil fuels for generation, particularly natural gas, has affected rates. As those fuel costs inevitably rise, utilities must repeatedly seek higher rates for consumers. The REST rules are an attempt by the Commission to control rates in the long term by promoting the deployment of renewable generation that has zero or very low fuel costs. To be sure, there are additional benefits to the environment and the reliability of the grid, but these effects are secondary to the goal of stabilizing rates in the long run.

The majority of commissioners who voted for the REST rules did so because, after seeing rate case after rate case filed in response to the rising price of natural gas, we determined that the REST rules were reasonably necessary to break the cycle and bring rates under control. When I cast my vote in favor of the REST rules, I pointed out that "APS in the last year and a half has been before this Commission requesting rate increases of between \$30 and \$40 per month for natural gas."<sup>5</sup> I stated, "If we don't pass this order, as we've heard it will have dire consequences. Renewable energy in Arizona will grind to a halt. We will continue to send billions of dollars out of state for natural gas instead of investing that money in Arizona."<sup>6</sup>

Commissioner Mayes also addressed the rate impact of the utilities' dependence on fossil fuels when she cast her vote for the REST rules. "[E]very Commissioner on this bench is painfully aware of the fact that utilities have been beating a path to the Commission's door asking for one rate increase after another, complaining that they have had to do so because of the price of natural gas."<sup>7</sup> She concluded, "Passing the RES will help ween [sic] our state off of its addiction to expensive fossil fuels and put us on a pathway to energy independence."<sup>8</sup>

Commissioner Wong explained his vote in support of the REST rules by saying that we need to encourage the development of renewable energy because of the intense "economic competition" for fossil fuels in the global market that "eventually would have an impact on America in terms of our sources of oil and natural gas, as well eventually [on] Arizona."<sup>9</sup> He

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<sup>3</sup> *Id.* at 295, 816.

<sup>4</sup> *Id.* at 296, 817.

<sup>5</sup> Decision No. 69127, Special OM Transcript, Vol. II page 351.

<sup>6</sup> *Id.* at 350.

<sup>7</sup> *Id.* at 340.

<sup>8</sup> *Id.* at 341.

<sup>9</sup> *Id.* at 335.

stated that “the time is now to move forward so that we can have an effective commercialization of this renewable energy.”<sup>10</sup>

Commissioner Pierce’s argument that the core provisions of the REST rules do not fall within the Commission’s exclusive ratemaking powers is logically flawed.

In his argument that the core provisions of the REST rules do not fall within the Commission’s exclusive ratemaking authority, Commissioner Pierce stated:

In this case, **the Commission argues that the core provisions of the REST rules constitute ratemaking because they will impact rates.** While the REST rules will certainly impact rates – predominantly by raising rates in the short-term, but stabilizing rates in the long-term – **adopting an “impact-on-rates test” would be a terrible method for delineating the boundaries of ratemaking policies.** Thousands of public policies impact rates, such as air quality standards, property taxes, tort laws, and labor laws. In light of the Commission’s exclusive ratemaking authority under the Arizona Constitution, the Court should reject an “impact-on-rates test” for determining whether a policy constitutes ratemaking. **Such a test would suggest that all of the foregoing public policies – air quality standards, property taxes, tort laws, and labor laws – could only be established by the Corporation Commission.**<sup>11</sup>

This is a classic straw man argument – a logical fallacy where one attacks a distorted version of the opponent’s position and not the opponent’s actual position. The Commission is not arguing that the core REST rules are ratemaking merely because they will have an impact on rates – like property taxes, labor laws, or tort laws. Nor is it the Commission’s position that any policy that has an impact on rates could only be established by the Corporation Commission pursuant to its exclusive ratemaking authority. The Commission’s position is that it has exercised its ratemaking authority to govern utilities’ **resource portfolios** because, like transactions with affiliated corporations, they “could have a **direct and devastating impact on rates.**”<sup>12</sup> The core provisions of the REST rules, like the Affiliated Interest Rules, are reasonably necessary steps in ratemaking.

#### Conclusion

My colleague calls the Commission’s position regarding its exclusive ratemaking powers “extreme” because, in his view, it would destroy “the authority of the Legislature to adopt renewable energy standards of its own.”<sup>13</sup> He concludes, “Because the Legislature could also

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<sup>10</sup> *Id.* at 337.

<sup>11</sup> Amici Curiae Brief of Commissioner Pierce and Representative Kirk Adams, at 12, *Roy Miller, et al. v. Arizona Corp. Comm’n, et al.*, No. CV 08-0196 SA (filed June 27, 2008) (internal citations omitted) (emphasis added).

<sup>12</sup> *Woods* at 294, 815 (emphasis added).

<sup>13</sup> Amici Curiae Brief of Commissioner Pierce, *supra* note 11, at 1-2. In footnote 1 on page 2 of his brief, Commissioner Pierce claims that “Every other state to adopt renewable energy standards has done so via its legislative authority.” This is simply not true. Both Colorado and Washington adopted renewable energy standards by ballot initiative and New York’s Public Service Commission adopted that state’s renewable portfolio standard. See <http://www.dsireusa.org>.

adopt renewable energy standards, the core provisions of the REST rules do not exclusively reside with the Commission.”<sup>14</sup> This begs the question that the Legislature has such authority.

If the REST rules are ratemaking, then the necessary implication is that the Legislature could not adopt renewable standards for public service corporations, but that does not mean that the Legislature could do nothing in setting energy policy for the state. It could pass a renewable energy standard that applies to municipalities, like Salt River Project which the Commission does not regulate, and implement tax policies to encourage the use of renewable energy by both consumers and utilities. I disagree with my colleague that this is an “extreme” position.

Sincerely,



William A. Mundell, Commissioner  
Arizona Corporation Commission

Attachment

Cc: Chairman Gleason  
Commissioner Hatch-Miller  
Commissioner Mayes  
Commissioner Pierce  
Brian McNeil  
Janice Alward  
Lyn Farmer  
Ernest Johnson  
Rebecca Wilder  
Attorney General Terry Goddard  
Parties to the Record

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<sup>14</sup> Amici Curiae Brief of Commissioner Pierce, *supra* note 11, at 13.

**COMMISSIONERS**  
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BARRY WONG



**ARIZONA CORPORATION COMMISSION**

Brian McNeil  
Executive Director

Direct Line: (602)542-3935  
Fax: (602)542-0752  
E-Mail [wmundell@azcc.gov](mailto:wmundell@azcc.gov)

December 12, 2006

The Honorable Terry Goddard  
Attorney General  
State of Arizona  
1276 West Washington  
Phoenix, AZ 85007

Re: Renewable Energy Standard and Tariff Rules; Docket No. RE-00000C-05-0030;  
Decision No. 69127

Dear Attorney General Goddard:

I am writing to encourage you to certify the new Renewable Energy Standard and Tariff (REST) Rules approved by the Arizona Corporation Commission in Decision No. 69127. Because I feel that the passage of these rules is so important for the future of the state of Arizona, I am compelled to write you today to contradict the assertion that the Commission lacks the authority under the Arizona Constitution to enact the core provisions of the REST Rules.

Before beginning, I want to make clear that I respect the independence of your office and understand that your process for the evaluation of any rules package is based on a legal analysis and not a popular vote. This letter is in no way an attempt to interfere with your process or to instruct you in how to go about reviewing the REST Rules package. I am merely attempting to share with you my perspective on a matter to which I have devoted substantial time and thought.

As you are well aware, pursuant to A.R.S. § 41-1044(B), your office reviews the rules to ensure that, among other things, they are within the Commission's power to enact. Some have taken the position that the Commission lacks the constitutional authority to make and enforce the rules.

"The Commission's ratemaking authority granted by Article 15, Section 3, of the Arizona Constitution extends beyond setting rates to include the promulgation of rules and regulations that are 'reasonably necessary steps in ratemaking.'"<sup>1</sup> While opponents of the rules correctly state the law on this point,<sup>2</sup> the

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<sup>1</sup> *Phelps Dodge Corp. v. Arizona Electric Power Co-op., Inc.*, 207 Ariz. 95, 111, 83 P.3d 573, 589 (App.2004), quoting *Arizona Corp. Comm'n v. State ex rel. Woods*, 171 Ariz. 286, 294, 830 P.2d 807, 815 (1992).

<sup>2</sup> Commissioner Gleason stated in his dissent at page 10 that "the courts have determined that the Commission has no regulatory authority under Article 15, Section 3 except that connected to its ratemaking power." This determination is less than clear. In *Woods*, the Arizona Supreme Court measured "the Commission's regulatory power by the doctrine apparently established by *Pacific Greyhound* and its progeny – that the Commission has no regulatory authority under Article 15, Section 3 except that connected to its ratemaking power." *Woods* at 294, 815. The court used the term "apparently" because the holding in *Pacific Greyhound* that "the legislature has the 'paramount power' to regulate in areas other than those concerned with ratemaking" is ambiguous. *Id.* at FN8. The *Woods* court decided that it "need not resolve this ambiguity at this time." *Id.* at 294, 815.

conclusion that the core provisions of the rules, R14-2-1804 (which requires utilities to satisfy an Annual Renewable Energy Requirement) and R14-2-1805 (which requires utilities to satisfy a Distributed Renewable Energy Requirement), are not reasonably necessary steps to ratemaking is incorrect.

The aforementioned rules are indeed reasonably necessary to ratemaking. This can be demonstrated by comparing the REST Rules to those rules in *Woods* that were found to be reasonably necessary to ratemaking and by contrasting them with those rules in *Phelps Dodge* that were struck down for lack of Commission authority.<sup>3</sup>

#### Similarity to *Woods*

In *Woods*, the Supreme Court of Arizona held that the Commission has the authority to promulgate its Affiliated Interest Rules under its constitutional ratemaking power. These rules required utilities to provide certain information to the Commission about the utility and its affiliates as well as to seek the Commission's approval prior to certain transactions. The court found that the Affiliated Interest Rules "arguably prevent utilities from endangering their assets through transactions with their affiliates. If such transactions damage a utility company's assets or net worth, the company will have to seek higher rates for survival. Thus, transactions with affiliated corporations could have a direct and devastating impact on rates."<sup>4</sup> The Affiliated Interest Rules were adopted by the Commission in response to the formation of holding companies by APS, the largest public utility in Arizona, and TEP. The court took notice that TEP nearly went bankrupt as a result of its reorganization and subsequent transactions with its affiliates. While TEP was able to obtain a dismissal of its creditors' petition under Chapter 11, it did so along with "a rate increase that it claimed was necessary to its financial survival."<sup>5</sup> The court also took notice that "the corporate conglomerate formed by Pinnacle West after the APS reorganization allegedly has faced serious financial difficulties, including financial problems of various affiliates and a threat by Pinnacle West to seek protection under Chapter 11 of the Bankruptcy Code."<sup>6</sup>

As a backdrop to the passage of the REST Rules, utilities' increasing dependence on fossil fuels, particularly natural gas, is already resulting in higher rates for consumers. In recent years, we have seen a series of rate cases by APS largely driven by rising fuel costs, primarily natural gas.<sup>7</sup> In each case, APS has claimed that these increases are necessary for its financial health and reiterate the importance of avoiding a credit downgrade which would add billions of dollars in interest costs that consumers would ultimately pay. Simple economics tells us that as the demand for a commodity increases, without a corresponding increase in supply, the price of that commodity will also increase. Sunlight (arguably the most plentiful natural resource in Arizona), geothermal energy, and wind are free. The proposed REST Rules will, over time, arguably decrease utilities' dependence on fossil fuels, insulating customers from volatile fuel costs which, if their prices continue on their present course, will have a direct and devastating impact on rates.

It has also been alleged that the REST Rules "impermissibly interfere with the management prerogative of the Affected Utilities."<sup>8</sup> That is not the case. The court in *Woods* found that the Affiliated Interest Rules

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<sup>3</sup> Although the rules I discuss were struck down after the court found that the Commission lacked constitutional and statutory authority, I am only addressing the issue of the Commission's constitutional authority.

<sup>4</sup> *Woods* at 295, 816.

<sup>5</sup> *Id.* at 290, 811, FN4.

<sup>6</sup> *Id.*

<sup>7</sup> Coal and nuclear are also important components of the generation mix, each with its own set of challenges. Coal fired generation faces increasing emissions restrictions necessary to combat global warming. Safety and performance are becoming issues for our nation's aging nuclear facilities, not to mention the issue of where to store the spent fuel.

<sup>8</sup> Decision No. 69127, Gleason Dissent at 11.

did not "so interfere with management functions that they constitute an attempt to control the corporation rather than an attempt to control rates."<sup>9</sup> Noting the "strong potential that transactions between affiliates will affect rates"<sup>10</sup> the court recognized "the effect of corporate structures, and dealings within those structures, on utility rates"<sup>11</sup> and rejected the notion that such a conclusion would allow the ACC "to invade every management decision of utility companies under the guise of ratemaking."<sup>12</sup> By affirming the Commission's constitutional authority to promulgate the Affiliated Interest Rules, the court satisfactorily resolved the Commission's "concern that its regulatory authority over public utility companies would be weakened and bypassed by the establishment of holding companies."<sup>13</sup>

The utilities' growing use of natural gas, even as prices remain volatile and continue along an upward trajectory, also has the strong potential to affect rates. The court in *Woods* found, "It would subvert the intent of the framers to limit the Commission's ratemaking powers so that it could do no more than raise utility rates to cure the damage from inter-company transactions."<sup>14</sup> That finding is equally applicable here. Without the ability to exert some influence over a utility's generation choices *ex ante*, the Commission's regulatory authority over rates is weakened - forcing upon it a Hobson's choice of whether to exclude additional conventional generation from rate base, financially weakening the utility, or continuing to add into rate base the utilities' choice of fossil-fueled generation, pushing electric rates unreasonably higher with their escalating fuel costs. The REST Rules do not impermissibly invade management. They are an attempt to control rates, not the company. The Commission is not mandating the entire generation portfolio of the utilities. The companies are given wide latitude in what renewable resources they choose to use. The Distributed Generation requirement is necessary to promote the use of solar energy. Although solar photovoltaic systems currently have higher costs up front, sunlight is available at zero cost and is a virtually unlimited natural resource - the most abundant in Arizona where the sun shines an average 321 days a year.

The court in *Woods* found that the ACC "must certainly be given the power to prevent a public service corporation from engaging in transactions that will so adversely affect its financial position that the ratepayers will have to make good the losses, and it cannot do so in any common-sense manner absent the authority to approve or disapprove such transactions in advance. To put it simply, the Commission was given the power to lock the barn door before the horse escapes."<sup>15</sup> As the price of fossil fuels continue to rise, it has become apparent to the Commission that the horse is headed for the barn door and the REST Rules are absolutely necessary to prevent its escape.

#### Distinguished from *Phelps Dodge*

In *Phelps Dodge*, the Arizona Court of Appeals found that the Commission lacked authority under the Arizona Constitution<sup>16</sup> to promulgate certain rules contained in its Retail Electric Competition Rules. The court found R14-2-1611(A), which stated that market based rates were deemed to be just and reasonable, to be unconstitutional and that the Commission improperly delegated to the competitive marketplace its "duty to set just and reasonable rates that provide for the needs of all whose interests are involved, including public service corporations and the consuming public."<sup>17</sup> The court found that the rule

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<sup>9</sup> *Woods* at 296, 817.

<sup>10</sup> *Id.* at 296, 817.

<sup>11</sup> *Id.* at 295, 816.

<sup>12</sup> *Id.* at 295-96, 816-817.

<sup>13</sup> *Id.* at 290, 811.

<sup>14</sup> *Id.* at 296, 817.

<sup>15</sup> *Id.* at 297, 818.

<sup>16</sup> As I stated *supra* at FN3, the court in *Phelps Dodge* also found that the Commission lacked statutory authority to promulgate these rules, and I am only addressing the issue of the Commission's constitutional authority.

<sup>17</sup> *Phelps Dodge* at 108, 586.

prevented the Commission from fully performing its duty to set just and reasonable rates in violation of Article 15, Section 3, which "not only empowers the Commission to set just and reasonable rates" but "requires it to do so."<sup>18</sup>

The REST Rules 1804 and 1805 do quite the opposite of R14-2-1611(A). A significant portion of rates is dependent on the price of natural gas, which is driven by market forces and passed on to customers. The decision by utilities to rely on more and more gas fired generation was shaped by the market and, based on the information available at the time, seemed prudent. However, rapidly rising fuel costs are now putting the squeeze on customers. R14-2-1611(A) abdicated Commission oversight to the market while R14-2-1804 and R14-2-1805 increase the Commission's oversight, requiring utilities to obtain an increasing amount of power from renewable sources with zero, or very low, fuel costs. Rule 1611(A) weakened the Commission's ratemaking authority while Rules 1804 and 1805 strengthen that authority. If the Commission does not exert its authority *ex ante* over the type of generation utilities choose to employ, then the Commission has abdicated a significant part of ratemaking to the market in violation of its constitutional duty.

The court in *Phelps Dodge* also found R14-2-1609(C)-(J), which directed utilities to create an independent scheduling administrator to oversee access to transmission services, to be not reasonably necessary to ratemaking; therefore, the Commission did not have the power to promulgate that rule under Art 15, Section 3. The court found that rule to be similar to those provisions found to be outside the Commission's ratemaking authority in *US West I*.<sup>19</sup>

The REST Rules 1804 and 1805 bear no similarity to R14-2-1609(C)-(J). In fact, nowhere in the REST Rules are utilities required to create an independent agency to administer any part of the program.

The court in *Phelps Dodge* also found that the Commission lacks constitutional authority to promulgate R14-2-1615(A), requiring divestiture of competitive generation assets and services, and (C), exempting electric distribution cooperatives from these requirements if they do not offer competitive services outside their service territories. The court found these rules to be aimed at controlling the utility rather than rates and stated that it failed to understand how requiring the divestiture of competitive generation affects rates.

Based on my recollection of the California electricity crisis in 2000 - 2001, it appears to me that divestiture indeed has an effect on rates, just not the intended effect. The objective of retail electric competition was to let competitive market forces drive down rates from those set for the utilities. That is certainly not what took place in the wake of forced divestiture in California. The REST Rules 1804 and 1805 are aimed at reducing the ratepayers' exposure to volatile market forces, such as the fluctuating costs of natural gas, by increasing the amount of energy obtained from generation with little or no fuel costs. Under the REST Rules package this will be done under the Commission's watchful eye<sup>20</sup> and not left to market forces alone.

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<sup>18</sup> *Id.* at 107, 585.

<sup>19</sup> *US West Communications, Inc. v. Arizona Corp. Comm'n*, 197 Ariz. 16, 3 P.3d 936 (App.1999) (deciding rules requiring local exchange carriers to provide equal access for customers to choose long-distance services and to enter interconnection arrangements with other telecommunications companies outside Commission's plenary authority).

<sup>20</sup> The REST Rules include provisions that will ensure that the Commission monitors how utilities comply with the Rules and what customers will have to pay. See R14-2-1808 (Tariff filings), R14-2-1812 (Compliance Reports), R14-2-1813 (Implementation Plans), R14-2-1815 (Enforcement and Penalties), and R14-2-1816 (Waiver Provisions).

The Honorable Terry Goddard  
December 12, 2006  
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I hope that you will take into account my argument that the passage of the core REST Rules falls under the Commission's plenary ratemaking authority under Article 15, Section 3 of the Arizona Constitution. I know that you will carefully consider all issues pertaining to the certification of these rules, and I appreciate the opportunity to comment on one aspect of the matters in dispute.

Sincerely,

A handwritten signature in black ink, appearing to read "William A. Mundell". The signature is fluid and cursive, with a large initial "W" and a distinct "M".

William A. Mundell, Commissioner  
Arizona Corporation Commission

cc: Chairman Hatch-Miller  
Commissioner Gleason  
Commissioner Mayes  
Commissioner Wong  
Brian McNeil, Executive Director, Arizona Corporation Commission  
Chris Kempley, Chief Counsel, Legal Division  
Ernest Johnson, Director, Utilities Division  
Lyn Farmer, Chief Administrative Law Judge, Hearing Division  
Heather Murphy, Public Information Officer  
Parties of Record