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ARKANSAS PUBLIC SERVICE COMMISSION

FILED

IN THE MATTER OF AN INVESTIGATION)
REGARDING ENTERGY ARKANSAS, INC.'S)
CONTINUED PARTICIPATION IN THE)
ENERGY SYSTEM AGREEMENT, AND THE)
FUTURE PROTECTION OF ITS RATEPAYERS)

DOCKET NO. 04-023-U
ORDER NO. 1

ORDER OF INVESTIGATION

Entergy Corporation

Entergy Corporation (“Entergy”) generates, transmits, and delivers electricity to 2.6 million utility customers in Arkansas, Louisiana, Mississippi, and Texas through five wholly-owned retail electric utility subsidiaries: Entergy Arkansas, Inc. (“EAI”), Entergy Gulf States, Inc. (“EGSI”), Entergy Louisiana, Inc. (“ELI”), Entergy Mississippi, Inc. (“EMI”), and Entergy New Orleans Inc. (“ENOI”) (collectively, “the Entergy Operating Companies” or “EOCs”). Entergy is a registered public utility holding company under the Public Utility Holding Company Act of 1935. Entergy’s wholesale transactions and sales from System Energy Resources, Inc. (“SERI”), a wholly-owned subsidiary that owns or leases 90 percent of the Grand Gulf Nuclear Generation Plant (“Grand Gulf”), are regulated by the Federal Energy Regulatory Commission (“FERC”). The rates and other activities of the EOCs are regulated by the state utility commissions, or in the case of ENOI, by the City Council of New Orleans (“CNO”).

The Entergy System Agreement

The Entergy System Agreement (“System Agreement”) is a FERC-jurisdictional agreement that allocates certain costs among the EOCs. There have been three Entergy

System Agreements: (1) The Memorandum Re Administration of Intra-System Transactions and System Planning and Development, dated June 1, 1951; (2) the 1973 System Agreement; and (3) the 1982 System Agreement (“1982 Agreement” or “current System Agreement”), which is the currently effective System Agreement.

There are seven Service Schedules under the System Agreement. These Service Schedules govern the after-the-fact allocation of the benefits and costs associated with the System Agreement. The Service Schedules are:

- Service Schedule MSS-1 (Reserve Equalization), which allocates the costs of reserve capacity;
- Service Schedule MSS-2 (Transmission Equalization), which equalizes imbalances of ownership costs associated with certain transmission system facilities owned and operated by each EOC;
- Service Schedule MSS-3 (Exchange of Electrical Energy Among the Companies), which allocates energy costs among the EOCs on an hourly after-the-fact basis;
- Service Schedule MSS-4 (Unit Power Purchase), which addresses unit power transactions between EOCs;
- Service Schedule MSS-5 (Distribution of Revenue from Sales Made for the Joint Account of All the Companies), which distributes among the EOCs the net balance for joint account sales;
- Service Schedule MSS-6 (Distribution of Operating Expenses of System Operations Center), which allocates the costs of the System Operations Center among the EOCs; and
- Service Schedule MSS-7 (Merger Fuel Protection Procedure), which addresses, for electing EOCs, increases in fuel and purchase power costs as a result of the merger between Entergy and Gulf States Utilities Company. EGSI was required by FERC order to participate in MSS-7, and ELI was the only other EOC that elected to participate.

Article I, Section 1.01, of the System Agreement, provides that the System Agreement may be terminated “by mutual agreement of the Companies.” Section 1.01

further provides: “Notwithstanding this, any Company may terminate its participation in this Agreement by ninety-six (96) months written notice to the other Companies hereto.”

The History of Litigation Related to the System Agreement

EAI’s participation in the System Agreement has embroiled it, and this Commission, in protracted litigation for over twenty years. That litigation began in 1982, when Entergy and its EOCs filed two wholesale power contracts for approval with the FERC. The first was the System Agreement in substantially the same form as it is today. The second was the Unit Power Sales Agreement (“UPSA”), which, as filed, allocated the costs of the Grand Gulf nuclear generation plant (“Grand Gulf”) to ELI, EMI, and ENO, with no costs assigned to Arkansas. Grand Gulf had originally been scheduled for construction and ownership by EMI, but EMI was unable to complete construction because of cost overruns and financing difficulties. A new corporate subsidiary, SERI, was created for the purpose of owning and finishing the construction of Grand Gulf, which had a total construction cost of \$3.3 billion when it went into service in July 1985.

These filings resulted in two lengthy trials, in which this Commission actively participated. In particular, this Commission vigorously opposed the proposals by other parties to allocate Grand Gulf costs to Arkansas ratepayers, as well as proposals by the Louisiana Public Service Commission (“LPSC”) and other parties to fully “equalize” production costs across the Entergy system. In addition to the FERC litigation, the Commission engaged in retail proceedings in an effort to protect Arkansas ratepayers from Grand Gulf costs. In response to those proceedings, Entergy sued the Commission in both state and federal courts.

In 1985, the FERC issued its Opinion No. 234 in the Grand Gulf case, in which it ruled on both the System Agreement and the UPSA. It refused to impose full production cost equalization and instead approved the System Agreement substantially as filed. However, it also adopted a proposal by the LPSC to allocate 36% of Grand Gulf costs to Arkansas. The key justification for this decision was the FERC's finding that all the generating units on the Entergy System, including Grand Gulf, were planned and constructed not for the benefit of individual EOCs but for the system as a whole. Therefore, according to the FERC, production costs should be "roughly equal" among the EOCs, which result would be achieved by the combination of the System Agreement and the UPSA.

Following the issuance of Opinion No. 234, the Commission's retail proceedings and related litigation were resolved through a settlement that required Entergy shareholders to absorb 1/5 of Arkansas' 36% allocation of the costs of Grand Gulf. The Commission's decision to approve that settlement was ultimately vindicated by the United States Supreme Court's ruling in *Mississippi Power & Light v. Mississippi*, 487 U.S. 354 (1988). In *Mississippi Power & Light*, the Court reviewed a ruling by the Mississippi Supreme Court that required the Mississippi Public Service Commission ("MPSC") to investigate the prudence of Grand Gulf costs and disallow any costs deemed imprudent. The Supreme Court reversed that ruling, holding that the FERC's allocation of Grand Gulf costs constituted a "filed rate" which preempted state regulatory commissions from disallowing any such costs as imprudent. As a result of EAI's Grand Gulf allocation, we estimate that Arkansas retail ratepayers have paid approximately \$3 billion in higher electric rates over the 1985-1998 time frame. As a

result, EAI's electric rates were approximately 25% higher than they would have been if EAI had been allocated none of Grand Gulf.

Opinion No. 234 was ultimately affirmed by the United States Circuit Court of Appeals in *City of New Orleans v. FERC*, 875 F.2d. 903 (1989). This affirmance, however, did not end the litigation associated with the System Agreement, but instead merely provided fuel for the fire. A near-continuous series of FERC cases regarding the appropriate allocation of costs among the EOCs ensued. These disputes were made possible, in large part, by the "open-ended" funding laws for the LPSC and CNO, which require Entergy, and in turn its ratepayers, to pay all of the LPSC's and CNO's litigation expenses regardless of success or failure. In the case of the LPSC, this includes a large New Orleans law firm and an Atlanta, Georgia, consulting firm. In the case of CNO, this includes a large Washington, D.C., law firm and a Colorado based consulting firm. The outside attorneys and consultants for the LPSC and for CNO have been paid millions of dollars over the years, many times for pursuing litigation aimed at shifting Louisiana costs to Arkansas ratepayers. Although we have often been able to work cooperatively with other state regulators, including the LPSC and CNO, on issues other than the System Agreement, it has been this Commission's experience that, as regards the System Agreement, Louisiana's "open-ended" funding arrangement for outside attorneys and consultants results in an unfettered litigation machine. While we cannot alter how the Entergy regulators in Louisiana choose to direct their resources, we can and should consider how EAI's ratepayers can be protected from becoming the target again of Louisiana's "no expense spared" litigation machine.

Despite its limited resources, this Commission vigorously participated in each of those cases in order to protect the rights of Arkansas ratepayers. Those cases included:

- A complaint by the LPSC and CNO about the prudence of the sale, previously approved by this Commission, of excess generating capacity owned by EAI;
- The appropriate allocation of costs and benefits associated with Entergy's acquisition of Gulf States Utilities;
- A challenge by the LPSC and the MPSC to the justness and reasonableness of Entergy's allocation of the costs of extended reserve shutdown units;
- A challenge by the LPSC and CNO to the right of EAI and its ratepayers to retain the benefits of Arkansas coal-fired generation following the implementation of retail open access in Arkansas;
- A complaint by the LPSC to change the allocation of the costs of interruptible generation; and
- A challenge by the LPSC to the allocation of sulfur dioxide credits.

In June 2001, the LPSC filed a complaint at the FERC, once again attempting to impose "full production cost equalization" on the Entergy system. The LPSC claims that it is now unfair for Arkansas ratepayers to enjoy the benefits of EAI's low-cost coal capacity. They make this claim despite the fact that Arkansas ratepayers have paid the costs of those units since they went into service over twenty years ago. Now, the LPSC claims, Arkansas ratepayers also should help pay for the high fuel costs of natural gas generation owned by ELI and ENO, as well as for the very expensive Vidalia hydro-electric generation plant ("Vidalia") located in Vidalia, Louisiana. The LPSC's complaint claimed that its high production costs should be shifted from Louisiana to Arkansas, with the result that retail rates in Arkansas would increase annually by hundreds of millions of dollars. Additionally, the LPSC's full production cost equalization proposal would shift jurisdiction over EAI's production costs from this Commission to the FERC and allow other jurisdictions to impose uneconomic planning decisions and costs on Arkansas ratepayers.

The ability of other jurisdictions to inequitably shift high costs to Arkansas ratepayers under the LPSC's proposal is graphically illustrated by the Vidalia contract. The Vidalia contract is a take and pay contract entered into in 1985 between the owners of Vidalia and ELI. The LPSC approved and encouraged ELI to sign the contract, citing purely local benefits such as a higher tax base and greater employment opportunities. The planning studies presented by ELI in support of the contract were based solely on its costs and benefits to ELI. In 1990, the LPSC issued an order clarifying its earlier approval of the Vidalia contract and providing that the entire cost of the contract would be recovered from ELI ratepayers through its fuel adjustment clause. The facility began commercial operations that same year.

In addition to approving the contract and requiring that its costs be borne by ELI ratepayers, the LPSC directed ELI to structure the contract's pricing so that it dramatically increases in the later years. Thus, the price of Vidalia's output was \$65 per mWh during the first 8 years of the contract, after which it will gradually increase to \$205 per mWh in the year 2010. Thereafter, the contract price will decrease to \$150 per mWh in the later years of the contract. These prices¹ are substantially above market price, as well as substantially above the costs of Entergy's own generation.

In 2002, the LPSC initiated a retail challenge regarding the prudence of ELI's management of the Vidalia contract, contending that, at some point, ELI should have made an effort to renegotiate the pricing. This docket resulted in a Settlement Agreement (the "Settlement") between ELI and the LPSC whereby ELI would seek to "mark to market" the Vidalia contract, such that all costs above market prices would be

¹ For purposes of comparison, the Commission notes that Arkansas Electric Cooperative Corporation's Arkansas hydro-electric power cost averages approximately \$28 per mWh.

written off for tax purposes, with the resulting savings being divided between ELI and ELI ratepayers. The annual benefit of the Settlement to ELI ratepayers over the next 8 years is estimated to be at least \$11 million. The total benefit to ELI ratepayers of the Settlement could reach as high as \$671 million over the life of the contract. The benefits of the LPSC Settlement will not be shared with Arkansas ratepayers.

The history of the Vidalia contract demonstrates that the contract was planned and executed solely for the benefit of Louisiana, and that the LPSC played a key role in directing both its execution and pricing. Nevertheless, in its FERC complaint for full production cost equalization, the LPSC insists that the full cost of Vidalia should now be spread among all the EOCs, with EAI bearing approximately 25% of the cost.

This Commission, through its counsel, consultants, and staff, participated aggressively in every phase of Louisiana's FERC complaint in an effort to avoid any negative impact to Arkansas ratepayers. These efforts included three rounds of pre-filed written testimony, numerous depositions, three legal briefs, and seven straight weeks of trial at the FERC. No effort was spared in attempting to persuade the FERC-appointed Presiding Administrative Law Judge ("Presiding Judge") that the LPSC's proposal would deprive Arkansas ratepayers of the benefits of low-cost generating capacity for which they have paid and rob this Commission of its jurisdiction over the majority of EAI's costs.

Following the conclusion of the trial, the FERC appointed a second ALJ to serve as a Settlement Judge and assist the parties in attempting to reach a mutually agreeable resolution of the contested issues. Once again, this Commission participated fully in every phase of the settlement discussions in an attempt to mitigate the potential impacts of an adverse ruling on Arkansas ratepayers. Unfortunately, the Commission's efforts,

including reasonable settlement offers, were rebuffed by the LPSC, and no settlement agreement was achieved.

On February 6, 2004, the Presiding Judge issued his Initial Decision on the LPSC's complaint. Most importantly, the Commission's litigation efforts were successful in avoiding the imposition of the LPSC's full production cost equalization proposal, which could have cost Arkansas ratepayers hundreds of millions of dollars more per year. However, the Presiding Judge did determine that Louisiana is entitled to relief and imposed an over/under production cost bandwidth remedy² that will require EAI to provide compensation to Louisiana in order to mitigate the perceived production cost disparities among the EOCs. While this Commission has not yet had sufficient time to fully evaluate the financial impacts of the Presiding Judge's decision, we have preliminarily estimated that it would cost Arkansas ratepayers approximately \$125 million at retail for the year 2003 alone, and, on average, \$113 million at retail annually for the period 2004 through 2011.³ The remedy, however, will not go into effect unless and until it is approved by the FERC Commissioners.

Further, in determining that the LPSC is entitled to relief, the Presiding Judge ruled that the "full" costs of the Vidalia contract should be included in the calculation of Louisiana's production costs, which, in conjunction with the application of the over/under production cost bandwidth remedy, means that EAI's ratepayers will be required to help Louisiana pay for Vidalia. The Commission's preliminary estimate is that EAI's share of Vidalia costs will be approximately \$25 million in the year 2003,

² The Presiding Judge recommended a +/- 7.5% annual maximum bandwidth deviation from the system average production cost designed to work in tandem with a +/- 5% 3-year rolling average bandwidth deviation.

³ Assuming stable gas prices and the current retail/wholesale load ratio.

increasing to \$40 million by the year 2012. While the costs of the Vidalia contract are of significantly smaller magnitude than those of Grand Gulf, the comparison between the two is inescapable. If the Presiding Judge's decision is affirmed on appeal, Arkansas ratepayers may, once again, be required to help pay for an electric generation plant located in another state, despite the fact that the Vidalia capacity is not needed in Arkansas and was not approved by this Commission.

The Vidalia contract is a major driver of Louisiana's "high production costs." But for the Vidalia contract, Louisiana's "high" electric production costs over the next eight years would be approximately \$1 billion less.⁴ Yet, through its proposed application of the System Agreement, Louisiana now seeks to shift the "high" costs of its Vidalia decision to Arkansas and other retail jurisdictions. But for, (1) the System Agreement, and the cost shifting manner in which Louisiana would have it interpreted and applied, and (2) the FERC's 1985 determination that all the generation units on the Entergy System were planned and constructed not for the benefit of individual EOCs but for the system as a whole, it is likely that Louisiana would have been required to bear the "high cost" consequences of its own uneconomic decisions.

In addition to the immediate negative impact of Vidalia on EAI's ratepayers, the Commission is deeply concerned that, in the future, the responsibility for other uneconomic high cost generation plants or capacity contracts may again be shifted from other EOCs to EAI and its Arkansas ratepayers. Such costs may result from future decisions made in other jurisdictions, *e.g.*, Vidalia II, or costs that have already been incurred in other jurisdictions of which this Commission is not yet aware. In 1985, when

⁴ The approximate difference in full Vidalia cost and Vidalia priced at MSS-3 over the period 2004 through 2011.

this Commission reluctantly agreed to a settlement which allowed the partial pass-through of Grand Gulf costs in EAI's retail rates, it was believed that Grand Gulf would be a one-time "hit." However, unbeknownst to this Commission, in 1985, the LPSC had already set into motion the regulatory approvals that would result in Arkansas ratepayers now being required to pay 25% of the costs of the Vidalia contract. It is now apparent, because of EAI's participation in the Entergy System Agreement, and the Presiding Judge's application of an over/under production cost bandwidth remedy, that Arkansas ratepayers may be exposed to unknown future costs over which this Commission has no control.

Jurisdictional Authority

EAI is an Arkansas electric public utility as defined in Ark. Code Ann. §23-1-101(9) and, thus, subject to the supervisory and regulatory jurisdiction and authority of this Commission. The Commission has jurisdiction and authority over this matter pursuant to, but not limited to, the provisions of Ark. Code Ann. §§23-2-301, 23-2-302, and 23-2-310.

Initiation of Investigation

Pursuant to the above-cited statutory authority, and for the reasons set forth hereinabove, the Commission hereby establishes this investigative proceeding for the purpose of considering (1) whether EAI's continued participation in the Entergy System Agreement is in the best interest of its ratepayers; and (2) what steps can be taken by EAI and this Commission to protect EAI's ratepayers from future attempts by Louisiana, or any other Entergy retail regulator, to shift its high costs to Arkansas.

EAI shall file Initial Testimony in direct response to the above-stated purposes of this investigative proceeding within sixty (60) days of the date of this order. Initial

and/or Reply Testimony by the General Staff of the Commission and authorized Intervenor shall be filed within thirty (30) days of the date on which EAI's Initial Testimony is filed. An extended procedural schedule, including the setting of a public hearing(s), will be established by subsequent order.

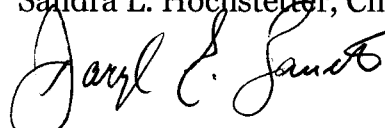
The Secretary of the Commission is hereby directed forthwith to serve this order on EAI via electronic transmission as well as by first class United States mail. Electronic service shall be accomplished on the date this Show Cause Order is issued.

BY ORDER OF THE COMMISSION

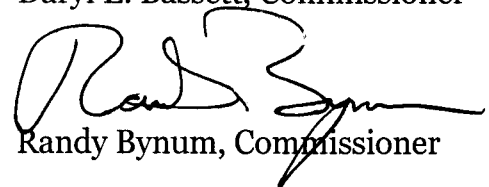
This 10th day of February, 2004.



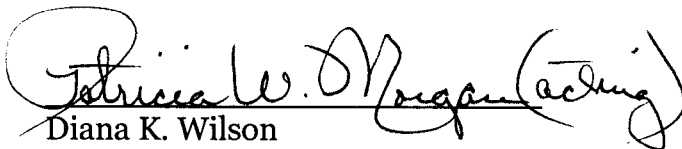
Sandra L. Hochstetter, Chairman



Daryl E. Bassett, Commissioner

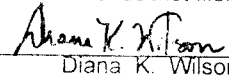


Randy Bynum, Commissioner



Diana K. Wilson
Secretary of the Commission

I hereby certify that the following order issued by the Arkansas Public Service Commission has been served on all parties of record this date by the U.S. mail with postage prepaid, using the address of each party as indicated in the official docket file.


Diana K. Wilson

Secretary of the Commission

Date 2-10-2004