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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission

DOCKETED

SEP 10 2002

1 WILLIAM A. MUNDELL  
2 CHAIRMAN  
3 JIM IRVIN  
4 COMMISSIONER  
5 MARC SPITZER  
6 COMMISSIONER

DOCKETED BY *nat*

7 IN THE MATTER OF THE GENERIC  
8 PROCEEDINGS CONCERNING ELECTRIC  
9 RESTRUCTURING ISSUES.

DOCKET NO. E-00000A-02-0051

10 IN THE MATTER OF ARIZONA PUBLIC  
11 SERVICE COMPANY'S REQUEST FOR  
12 VARIANCE OF CERTAIN REQUIREMENTS OF  
13 A.A.C. R14-2-1606.

DOCKET NO. E-01345A-01-0822

14 IN THE MATTER OF THE GENERIC  
15 PROCEEDING CONCERNING THE ARIZONA  
16 INDEPENDENT SCHEDULING  
17 ADMINISTRATOR.

DOCKET NO. E-00000A-01-0630

18 IN THE MATTER OF TUCSON ELECTRIC  
19 POWER COMPANY'S APPLICATION FOR A  
20 VARIANCE OF CERTAIN ELECTRIC  
21 COMPETITION RULES COMPLIANCE DATES.

DOCKET NO. E-01933A-02-0069

22 IN THE MATTER OF THE APPLICATION OF  
23 TUCSON ELECTRIC POWER COMPANY FOR  
24 APPROVAL OF ITS STRANDED COST  
25 RECOVERY.

DOCKET NO. E-1933A-98-0471

DECISION NO. 65154

**OPINION AND ORDER**

26 DATES OF HEARING: June 14, 2002 (pre-hearing); June 17, 18, 19, 20, 21, 27,  
27 and 28, 2002

28 PLACE OF HEARING: Phoenix, Arizona

ADMINISTRATIVE LAW JUDGE: Lyn Farmer

IN ATTENDANCE: William A. Mundell, Chairman  
Marc Spitzer, Commissioner

APPEARANCES: Mr. Jay L. Shapiro, FENNEMORE CRAIG and Mr.  
Michael R. Engleman, DICKSTEIN, SHAPIRO,  
MORIN & OSHINSKY on behalf of Panda Gila River,  
L.P.;

Mr. Lindy Funkhouser, Director, and Mr. Scott S.  
Wakefield, Chief Counsel, on behalf of the Residential  
Utility Consumer Office;

Mr. Thomas L. Mumaw, Senior Attorney, PINNACLE  
WEST CORPORATION and Mr. Jeffrey B. Guldner,

1 SNELL & WILMER; on behalf of Arizona Public  
Service Company;

2 Mr. Raymond S. Heyman, ROSHKA, HEYMAN &  
3 DeWULF; on behalf of Tucson Electric Power  
Company;

4 Mr. Lawrence V. Robertson, Jr., MUNGER  
5 CHADWICK, on behalf of Sempra Energy Resources  
and Southwestern Power Group II;

6 Mr. William P. Sullivan, and Mr. Michael A. Curtis,  
7 MARTINEZ & CURTIS, P.C., on behalf of Reliant  
Energy Resources;

8 Mr. Steven Lynn Wene, MOYES, STOREY; on behalf  
9 of PPL Southwest Generation Holdings, LLC; PPL  
EnergyPlus, LLC; and PPL Sundance Energy, LLC;

10 Mr. Walter W. Meek on behalf of the Arizona Utility  
11 Investors Association;

12 Mr. Randall H. Warner, JONES, SKELTON &  
13 HOCHULI, P.C., and Mr. Daniel W. Douglass, LAW  
OFFICES OF DANIEL W. DOUGLASS, on behalf of  
AES NewEnergy and Strategic Energy, L.L.C.;

14 Mr. Greg Patterson on behalf of the Alliance;

15 Mr. Roger K. Ferland, QUARLES & BRADY  
16 STREIGH LANG, L.L.P., on behalf of Harquahala  
Generating Company;

17 Mr. Gary A. Dodge, HATCH, JAMES & DODGE, P.C.,  
18 on behalf of Arizona for Choice and Electric  
Competition;

19 Mr. Robert J. Metli, CHEIFETZ & IANNITELLI, on  
20 behalf of Citizens Communications Company; and

21 Mr. Christopher K. Kempley, Chief Counsel and Ms.  
22 Janet F. Wagner, Staff Attorney, Legal Division, on  
behalf of the Utilities Division of the Arizona  
Corporation Commission.

23 **BY THE COMMISSION:**

24  
25 On October 18, 2001, Arizona Public Service Company ("APS") filed a Request for a Partial  
26 Variance to A.A.C. R14-2-1606(B) and for Approval of a Purchase Power Agreement  
27 ("Variance/PPA") (Docket No. E-01345A-01-0822).

28 ...

1 A Procedural Conference was held on December 5, 2001, to discuss procedural issues and the  
2 appropriate scope of the proceeding. APS filed direct testimony on December 12, 2001, and the  
3 parties filed briefs on December 19, 2001.

4 By Procedural Order issued January 22, 2002, the Commission opened this generic docket on  
5 electric restructuring (Docket No. E-00000A-02-0051). The Commissioners, through a series of  
6 letters, requested that the parties respond to questions about electric competition.

7 On January 28, 2002, Tucson Electric Power Company ("TEP") filed a Request for Variance  
8 (Docket No. E-01933A-02-0069).

9 On January 30, 2002, the Commission's Utilities Division Staff ("Staff") filed a Response to  
10 the Procedural Order establishing the generic docket and requested consolidation of all related  
11 electric competition dockets, including the generic docket, the APS variance request, the TEP  
12 variance request, the Arizona Independent Scheduling Administrator ("AISA") inquiry, and the TEP  
13 request to amend its market generation credit, Docket No. E-01933A-98-0471.

14 A Procedural conference was held on January 31, 2002, to discuss procedural issues and on  
15 February 8, 2002, a Procedural Order was issued consolidating the dockets, ordering Staff to file a  
16 Staff Report in the Generic Docket, and establishing a hearing date on APS' Variance/PPA  
17 application.

18 Intervention was granted to the following: the Residential Utility Consumer Office  
19 ("RUCO"); Reliant Resources, Inc. ("Reliant"); Panda Gila River, LP (Panda"); Arizona Competitive  
20 Power Alliance ("Alliance"); Arizonans for Electric Choice and Competition ("AECC"); Harquahala  
21 Generating Co., LLC ("Harquahala"); Arizona Utility Investors Association ("AUIA"); Sempra  
22 Energy Resources ("Sempra"); Southwestern Power Group II, Inc. ("SWPG"); AES New Energy Inc.  
23 ("AES NE"); Strategic Energy, LLC ("Strategic"); Toltec Power Station, LLC; Bowie Power Station,  
24 LLC; PG&E National Energy Group; Arizona Transmission Dependent Utility Group; Duke Energy  
25 Arlington Valley, LLC; Duke Energy North America, LLC; Kroger & Co.; Land & Water Fund of  
26 the Rockies; Arizona Cogeneration Association; Conoco, Inc.; APS Energy Services Co., Inc.;  
27 Department of Defense; Stirling Energy System; Arizona Consumer Council; Southwest Energy  
28 Efficiency Project; and Arizona Community Action Association ("ACAA").

On March 19, 2002, Panda Gila River, L.P. ("Panda") filed a Request for Order to Show  
Cause.

On March 22, 2002, Staff filed its Staff Report in this Generic Docket, summarizing the  
parties' answers to the Commissioners' questions and making recommendations about electric

1 restructuring.

2 On April 22, 2002, APS filed a Motion for Determination of Threshold Issue, which indicated  
3 that APS intended to submit its "30-day letter" regarding the asset transfer on approximately August  
4 1, 2002, irrespective of the Commission's resolution of the Variance/PPA request or the proceedings  
5 in the generic electric docket.<sup>1</sup>

6 On April 25, 2002, the Commission held a Special Open Meeting at which the Commission  
7 stayed the APS Variance/PPA hearing, denied Panda's Request for an OSC, and directed that certain  
8 issues be addressed in the Generic Docket.

9 By Procedural Order issued on May 2, 2002, a hearing was set on the issues identified by the  
10 Commission, including: the transfer of assets and associated market power issues; Code of Conduct;  
11 Affiliated Interest Rules; and jurisdictional issues raised by Chairman Mundell, collectively referred  
12 to as "Track A" issues. Track B, Competitive Procurement, was also established. The Procedural  
13 Order also put the parties and the general public on notice that the Commission may initiate  
14 rulemaking(s), or, pursuant to A.R.S. § 40-252, after hearing, enter such orders as may be appropriate  
15 relating to electric restructuring, including variances from Commission rules and/or Decisions.

16 Notice of the hearing was published in newspapers of general circulation in the APS and TEP  
17 service areas and statewide between May 26 and June 6, 2002.<sup>2</sup>

18 The hearing was held as scheduled. No members of the public appeared to make public  
19 comment. Witnesses testified on behalf of APS, TEP, AUIA, AECC, RUCO, Panda, Harquahala,  
20 Sempra/SWPG, Reliant, AES NE/Strategic, and Staff.

21 By Procedural Order issued on July 10, 2002, TEP's application to amend its market  
22 generation credit was removed from this consolidated proceeding.

23 On July 10, 2002, the parties filed briefs.

### 24 BACKGROUND

25 On May 20, 1994, the Commission opened Docket No. U-0000-94-165 to investigate the  
26 introduction of retail electric competition. On December 26, 1996, the Commission issued Decision  
27 No. 59943, which adopted A.A.C. R14-2-1601 through 1616, the Retail Electric Competition Rules.  
28 Hearings were held on generic stranded cost issues, and on June 28, 1998, the Commission issued  
Decision No. 60977 on Stranded Costs. On August 10, 1998, in Decision No. 61071, the

<sup>1</sup> See footnote 3 to the Motion.

<sup>2</sup> Arizona Republic, Bisbee Daily Review, Sierra Vista Herald, Tri-Valley Dispatch, Douglas Daily Dispatch, Flagstaff  
Arizona Daily Sun, Holbrook Tribune/Silver Creek Herald, Parker Pioneer, Payson Round Up, Prescott Daily Courier,  
Sedona Red Rock News/Cottonwood Journal Extra/Camp Verde Journal/ Wickenburg Sun, Winslow Mail, Yuma Daily  
Sun, Arizona Daily Star, and the Tucson Citizen.

1 Commission adopted amended rules on an emergency basis, and on December 11, 1998, adopted the  
 2 emergency rules on a permanent basis in Decision No. 61272. On January 11, 1999, the Commission  
 3 issued Decision No. 61311, which stayed the Retail Electric Competition Rules and related decisions,  
 4 including Decision No. 60977.

5 On April 27, 1999, the Commission issued Decision No. 61677, which amended Decision No.  
 6 60977, the Commission's prior Stranded Cost decision. Decision No. 61677 ordered the Hearing  
 7 Division to issue a Procedural Order to set dates for consideration of stranded costs and unbundled  
 8 tariffs for each Affected Utility. The revised Retail Electric Competition Rules were published on  
 9 May 14, 1999 and public comment sessions were held. On May 18, 1999, APS filed for approval of  
 10 a settlement agreement and on June 9, 1999, TEP filed for approval of a settlement agreement.  
 11 Hearings were held on both applications, and the Commission issued Decision No. 61973 (October 6,  
 12 1999) in the APS docket, and Decision No. 62103 (November 30, 1999) in the TEP docket. On  
 13 September 29, 1999, the Commission issued Decision No. 61969, which approved the revised Retail  
 14 Electric Competition Rules ("Retail Electric Competition Rules"). In Decision No. 62924 (October  
 15 10, 2000) the Commission adopted clarifying revisions to the Retail Electric Competition Rules.

16 The Settlement Agreements provided and Decision Nos. 61973 and 62103 granted two-year  
 17 extensions of time, until December 31, 2002, for APS and TEP to separate assets (A.A.C. 1615(A)<sup>3</sup>)  
 18 and also granted a "similar two-year extension" for compliance with A.A.C. R14-2-1606(B)<sup>4</sup>. APS  
 19 planned to divest its competitive generation assets to a yet-to-be formed generation affiliate. The  
 20 Addendum to APS' Settlement Agreement also provided that: "[a]fter the extensions granted in  
 21 Section 4.1 have expired, APS shall procure generation for Standard Offer customers from the  
 22 competitive market as provided for in the Electric Competition Rules. An affiliated generation  
 23 company formed pursuant to this Section 4.1 may competitively bid for APS' Standard Offer load,  
 24 but enjoys no automatic privilege outside of the market bid on account of its affiliation with APS."  
 25 (4.1(3)).

26 <sup>3</sup> A.A.C. R14-2-1615(A) provides: "All competitive generation assets and competitive services shall be  
 27 separated from an Affected Utility prior to January 1, 2001. Such separation shall either be to an unaffiliated party or to a  
 28 separate corporate affiliate or affiliates. If an Affected Utility chooses to transfer its competitive generation assets or  
 competitive services to a competitive electric affiliate, such transfer shall be at a value determined by the Commission to  
 be fair and reasonable." ("Rule 1615(A)")

<sup>4</sup> A.A.C. R14-2-1606(B) provides: "After January 1, 2001, power purchased by an investor owned Utility  
 Distribution Company for Standard Offer Service shall be acquired from the competitive market through prudent, arm's  
 length transactions, and with at least 50% through a competitive bid process." ("Rule 1606(B)")

1 APS' Variance/PPA application stated that "adherence to the competitive bidding  
2 requirements of the Electric Competition Rules will not produce the intended result of reliable  
3 electric service for Standard Offer customers at reasonable rates" and requested that the Commission  
4 grant a partial variance to R14-2-1606(B) that would otherwise obligate APS to acquire all of its  
5 customers' Standard Offer generation requirements from the competitive market, and to approve a  
6 long-term purchase power agreement with its affiliate, Pinnacle West Capital Corporation  
7 ("PWCC").

8 TEP's Variance application requested that the Commission grant an extension of the  
9 compliance dates in Rule 1606(B) and Rule 1615(A) to either December 31, 2003, or six months  
10 after the Commission has issued a final order in this docket, whichever occurs later.

11 By Procedural Order issued February 8, 2002, the Commission determined that APS'  
12 Variance/PPA application required proceeding according to A.R.S. § 40-252 in addition to  
13 proceeding as a request for a rule variance. Our May 2, 2002, Procedural Order in this proceeding  
14 also stated that the parties and the general public are put on notice that the Commission may initiate  
15 rulemaking(s) or, pursuant to A.R.S. § 40-252, after hearing, enter such orders as may be appropriate  
16 relating to electric restructuring, including variances from Commission rules and/or Decisions and  
17 required notice to be given that provided as full notice and opportunity for participation on the part of  
18 the public as possible.

19 The Track A issues to be resolved in this portion of the docket are: Issue #1 Market Power;  
20 Issue # 2 Divestiture; Issue # 3 Code of Conduct/Affiliate Transactions; and Issue # 4 Jurisdictional  
21 Issues.

### ISSUE # 1 MARKET POWER

#### Staff

22 On the issue of the condition of the wholesale market, Staff finds and recommends:

- 23 1. The wholesale market is not currently workably competitive; therefore, reliance on that  
24 market will not result in just and reasonable rates.
- 25 2. APS has market power in its Phoenix Valley and Yuma load pockets.
- 26 3. TEP has market power in its Tucson load pocket.
- 27 4. The Commission should require APS and TEP to produce market power studies  
28 accompanied by market mitigation plans before allowing them to divest.
5. The wholesale market applicable to Arizona is poorly structured and susceptible to  
possible malfunction and manipulation.

**APS**

1 APS argues that the evidence presented at hearing demonstrated that its generation affiliate,  
2 Pinnacle West Electric Corporation ("PWEC") will not have unmitigated market power post-  
3 divestiture. APS states that all parties that conducted the Supply Margin Assessment ("SMA")  
4 analysis as used by the Federal Energy Regulatory Commission ("FERC") "came to the conclusion  
5 that APS passes the most recent and stringent market power test proposed by FERC in determining  
6 whether or not a wholesale electric market is functionally competitive." (APS Brief at pp 19-20).  
7 APS believes that the market power of generation owners within transmission-constrained areas is  
8 not caused by divestiture and will not be ameliorated by retention of load pocket generation, but will  
9 be mitigated by the "must-run" provisions of the AISA and the WestConnect protocols. Further, APS  
10 points out that A.A.C. R14-2-1609(I) requires that contracts for "must-run" generation must be in  
11 place prior to divestiture. APS believes that Staff's proposed new market power study is  
12 "unnecessary and assumes the existence of a problem requiring a solution." (APS Brief at p. 21)

**TEP**

13 TEP believes that there is not sufficient consensus in the record upon which the Commission  
14 can make a decision as to how to quantify market power and how to resolve market power issues as  
15 they arise. Consequently, TEP recommends that the issue of market power should be subject to  
16 further evaluation.

**Panda**

17 Panda agrees with APS' witness, Dr. Hieronymus' definition of market power as "the ability  
18 to profitably sustain an above-competitive price in the marketplace." Panda's witness, Dr. Roach,  
19 testified that APS has both transmission and generation market power in both the APS Market as a  
20 whole and in the APS Valley Market. Dr. Roach's load pocket-specific SMA analysis for the Phoenix  
21 load center found that APS' market power in the Valley Market is even more significant than its  
22 market power in the region at large. (Roach direct at p.15) Panda recommends that the Commission  
23 should find that APS has market power today, and that its affiliate will have market power in the  
24 future.

25 Although Panda does not believe that additional market power studies are necessary, it  
26 advises that if the Commission decides that market power analysis is essential, the SMA test, as  
27 adjusted by Dr. Roach, is the best approach to measuring market power. Dr. Roach identified three  
28 assumptions that tend to overstate the supply margin, which, according to him, results in an  
understatement of market power. He recommends modifying the SMA as applied by FERC to adjust

1 for those factors. Dr. Roach criticized APS' witness, Dr. Hieronymus' SMA analysis for not  
 2 accounting for the SMA test's inherent overstatement of supply margin; for not accounting for  
 3 capacity that is foreclosed from competing by APS; and for significantly overstating import capacity  
 into the APS region by including transmission facilities that APS does not own or control.

4 Panda believes that APS' market power can be mitigated through competitive procurement.  
 5 Panda believes that the market power problem in Arizona is not that there is an insufficient number of  
 6 competitors, but that APS is in a position to foreclose the opportunity for those competitors to  
 7 compete, such as with its proposed PPA which would allow APS to use its existing market power to  
 8 protect two facilities built and owned as merchant plants by its affiliates, thereby harming ratepayers  
 by forcing them to pay higher prices and bearing more market risk than necessary.

9 Panda also believes that APS' position on market power is "ironic". According to Panda,  
 10 when APS discusses whether it has market power, APS says it does not because of a "vast wholesale  
 11 market and over 11,000 MW of import capacity", but when claiming it cannot competitively bid, it  
 12 cites lack of competitors and existing transmission constraints. (Panda Brief at pp. 6-7)

### 13 Reliant

14 Reliant states that most parties "recognize that the transfer of all UDC generation assets to an  
 15 affiliate will result in a concentration of market resources that provide the opportunity for the affiliate  
 to exert market power on the wholesale generation market." (Reliant Brief at p. 4).

16 Reliant proposed a "two-prong" approach that it believes alleviates both the market power and  
 17 transmission-constraint issues. Reliant proposes a capacity auction that allows wholesale market  
 18 participants to acquire specific portions of the output of capacity transferred by the UDC to an  
 19 affiliate, and a competitive solicitation process structured as "slice of system" auctions. Bidders  
 20 would compete to provide a specific percentage of APS' daily load requirement, using staggered  
 21 delivery dates and varying contract lengths. Reliant believes that this is a potential market-based  
 22 solution to concerns about short-term market power. It would avoid unnecessary delay in the  
 23 implementation of competition for Arizona Standard Offer load, resulting in consumers receiving the  
 24 benefits of competition in a timely manner. Further, Reliant asserts, it allows for the divestiture of  
 generation assets and makes further market power studies unnecessary.

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AECC

1 AECC signed and supports the APS and TEP Settlement Agreements and continues to believe  
2 they are in the public interest. However, the AECC does not want the Commission to ignore critical  
3 policy issues such as “the potential that market power could unfairly impact retail prices after  
4 divestiture and after the termination of existing price caps”. (AECC Brief at p. 3) AECC notes that  
5 the “concerns expressed by APS and others about the near-term viability of the wholesale market  
6 make it difficult for divestiture to proceed within the time frame contemplated by the APS Settlement  
7 Agreement. [footnote omitted] APS, for example, has characterized the western wholesale market as  
8 ‘not functioning properly’ because liquidity has ‘gone in the tank’” (AECC Brief at p. 5, quoting Jack  
9 Davis). Further, AECC notes that to “the extent that the Commission is not enamored with the  
10 proposed PPA, but otherwise shares APS’ concerns about the wholesale market, the Commission will  
11 naturally be hesitant to allow divestiture to move forward on the current schedule without sufficient  
12 protections in place to protect the public interest.” (AECC Brief at pp. 5-6). AECC recommends that  
13 the parties, including the Commission, should seek a consensus approach to market power testing,  
14 monitoring, and mitigation, and should proactively seek adoption of that approach by FERC.

AUIA

14 AUIA believes that the threat of market power has been vastly overstated, and that the  
15 solution to the threat of market power can probably be found in Track B.

RUCO

16 RUCO believes that electric deregulation is “in trouble.” (RUCO Brief at p. 1) As support,  
17 RUCO states that “[e]lectricity wholesale markets in the western United States are dysfunctional and  
18 remain under federal price-cap controls” and that competition and its benefits have not materialized  
19 for Arizona’s small retail customers, who will be charged for the costs of transition. RUCO supports  
20 Staff’s recommendation that before divestiture is allowed to occur, a comprehensive market power  
21 study for the Arizona regional wholesale power market needs to be done. RUCO believes that the  
22 study should be performed on a cooperative basis with input from all parties through a technical  
23 advisory team, using computer-based modeling of strategic behavior. The results would be used to  
24 determine the future of electric restructuring in Arizona.

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**ISSUE # 2 DIVESTITURE OF COMPETITIVE GENERATION ASSETS****Staff**

On the issue of asset transfer, Staff recommends:

1. The Commission should immediately issue an order that stays Rule 1606.B, Rule 1615.A, and the transfer provisions of Decision No. 61973 and 62103 until the Commission can conclude that the wholesale market is workably competitive.
2. The Commission should initiate a rulemaking proceeding to amend Rule 1615.A.
3. The utilities should not be prohibited from transferring their generation assets. However, such transfers should not be permitted unless the transfer will serve the public interest.
4. Asset transfers will promote competition, and thereby serve the public interest, as long as the wholesale market is workably competitive.
5. In order to transfer its assets, a utility should file a market power study, a market mitigation plan, and a proposed code of conduct. It may be feasible for the Commission to consider these items in a consolidated proceeding.

Staff points out that when the Commission approved the Electric Competition Rules and the Settlement Agreements, all the parties thought that retail competition was imminent – that the wholesale market would be competitive; that a significant number of retail competitors would be entering the market; and that customers would leave the incumbent utility and purchase power from the new competitors. Instead, Staff argues, the “wholesale market has faltered, the new competitors have failed to materialize, and incumbent utilities have not lost customers in any meaningful number.” (Staff Brief at p. 2). Staff believes that the timing of the transfer is problematic. Staff states that “APS has admitted that implementation of the terms of the rules and the settlement agreements as they currently stand will put the public at risk.” (Staff Brief at p. 5, citing testimony of APS witness Davis).

In response to some witnesses’ recommendations to rely on FERC to police the market, Staff cites the General Accounting Offices’ (“GAO”) conclusion that FERC has not yet defined or implemented an effective regulatory and oversight approach for competitive energy markets, which means that FERC “lacks assurance that today’s energy markets are producing interstate wholesale natural gas and electricity prices that are just and reasonable.” (Mundell Ex. A at pp. 5-6) The timing problem is also apparent in the lack of a functioning Regional Transmission Organization (“RTO”). According to Staff, it is not possible to comply with the competitive bidding requirements of 1606(B) by the end of the year, and even APS seems to agree.

1 Because the circumstances that the rules were designed to address have not developed, because  
 2 asset transfer combined with an ineffective wholesale market places the public at substantial risk, and  
 3 because it “appears that reliance on FERC to police the wholesale market may be ill advised”, Staff  
 4 recommends that the Commission should not allow asset transfer until it is convinced that the transfer  
 5 is in the public interest. Staff advises that “[w]ithout conditions designed to address market structure  
 6 concerns, the transfer is not in the public interest.” (Staff Brief at p. 4, emphasis original).

7 Staff believes that before the Commission decides whether a particular utility should be allowed  
 8 to divest, the utility should indicate whether it wants to divest.<sup>5</sup> If a Company wants to divest, it  
 9 should file market power studies and a proposed code of conduct, Track B should be concluded, and  
 10 in any event, no reliability must-run generation (“RMR”) should be divested. Staff’s states that its  
 11 recommendations on divestiture may have implications for future rate setting, because if a utility  
 12 chooses to retain its assets, the Staff believes that the Commission should apply cost of service  
 13 principles when setting rates.

14 In response to APS’ argument that the Commission is bound by the Settlement Agreement, Staff  
 15 argues that the Commission is not contractually bound. Staff states that if a regulatory agency finds a  
 16 proposed settlement to be reasonable, the terms of the settlement form the substance of a decision that  
 17 binds all parties to the proceeding, and the approved agreement assumes the nature of an agency  
 18 decision enacted in the public interest, losing its private contractual character. (Citing Cajun Elec.  
 19 Power Coop., Inc. v. F.E.R.C., 924 F.2d 1132, 1135 (D.C. Cir. 1991). Staff also argues that it is  
 20 unlikely that a contract was formed due to the Commission’s amendments to the agreement. Staff  
 21 further argues that, assuming for the sake of argument that a contract exists, it is unenforceable  
 22 because the “alleged contract was based on the existence of a workably competitive wholesale  
 23 market, and because a workably competitive market does not exist, the purpose of the alleged  
 24 contract has been frustrated, thereby excusing performance.” (Staff Brief at p. 19)

### 25 APS

26 APS believes that divestiture will benefit APS customers in the long run and will not harm  
 27 them in the short run. It acknowledges that the benefits of divestiture are more long-term in nature,  
 28 while the “risks of the market loom today”. (APS Brief at p. 12) APS points out that through its  
 Settlement Agreement, its customers have protection against the market through June 2004, and that  
 intermediate to long-term protection for consumers is available through the proposed PPA.

<sup>5</sup> Staff recommends that utilities should inform the Commission within 30 days of the conclusion of Track B.

1 APS argues that no party has presented a compelling argument against divestiture. APS cites  
 2 other jurisdictions that have authorized divestiture without harm to consumers and in furtherance of  
 3 industry restructuring as support for its own divestiture. APS argues that Staff's preconditions to  
 4 divestiture are so ambiguous and onerous as to make timely divestiture impossible from both a  
 5 regulatory and commercial standpoint. APS states that claims of horizontal market power concerns  
 6 were not raised in 1999; no party suggested that another code of conduct was necessary to address  
 7 other affiliate issues; and that competitive bidding has always been tied to divestiture and divestiture  
 8 must occur first. APS believes that the parties' arguments on these issues are attempts to indefinitely  
 9 delay or unnecessarily condition divestiture.

10 APS states that divestiture has already been finally authorized by Decision No. 61073 and  
 11 Rule 1615(A), and cannot be delayed or stayed in these proceedings without breaching the APS  
 12 Settlement. According to APS, the Commission entered into a binding contract, and this  
 13 interpretation has been upheld by the Arizona Court of Appeals. APS states that Staff's claimed  
 14 change in circumstances, including the "failure of retail competition to develop as apparently Staff  
 15 had envisioned back in 1999, the existence of market power during a few hours of the year in  
 16 transmission constrained areas of APS service territory, the alleged 'loss' of Commission jurisdiction  
 17 over electric generation, and some non-specific concerns over the efficacy of the wholesale market"  
 18 actually are not a change in circumstances or "represent changes irrelevant to the issue of divestiture."  
 19 (APS Brief at p. 9). APS believes that the "failure of the wholesale competitive market to develop as  
 20 quickly as was once envisioned and the apparently inherent volatility and unpredictability of the  
 21 wholesale electric market is a legitimate concern." (APS Brief at p. 10) However, APS' solution to  
 22 that "legitimate concern" is approval of its PPA, not to delay divestiture. APS also argues that  
 23 another "dramatic change of circumstances since 1999" was the creation of a new and separate  
 24 generation affiliate.<sup>6</sup>

## 25 TEP

26 TEP has requested, in its Variance, an "extension of the compliance date in Rule 1615.A,  
 27 which requires that all competitive generation assets and competitive services be separated from  
 28 TEP." TEP believes that the date should be extended to either December 31, 2003 or six months  
 after the Commission issues a final order in this proceeding, whichever occurs later. In its Variance

<sup>6</sup> Although APS claims that "APS has been **required** by this Commission to create a new and separate generation affiliate" (APS Brief at p.9, emphasis added), the Electric Competition Rules (1615(A)) contemplate divestiture to either an "unaffiliated party or to a separate corporate affiliate or affiliates" and in Decision No. 61973 at page 10, we state that "[w]e also recognize the Company is making a business decision to transfer the generation assets to an affiliate instead of an unrelated third party", indicating that it was APS' choice to create a "new and separate generation affiliate".

1 application, TEP states that “given the recent history – and current state – of the western power  
2 markets, TEP believes that neither an immediate transition to the 50% competitive bid requirement or  
3 the generation separation requirement is prudent at this time.” (Variance Application at p. 4)

3 **Panda**

4 Generally, Panda supports the proposed divestiture of APS and TEP generation assets to an  
5 affiliate on the terms that were agreed to in the Settlement Agreements (i.e. that divestiture would be  
6 contemporaneous with competitive procurement). Panda believes that any divestiture of generation  
7 assets to affiliates should be conditioned on implementation of the competitive procurement  
8 framework as established in Track B. According to Panda, “[c]ompetitive procurement will yield  
9 substantial benefits to Arizona ratepayers because there is an emerging oversupply of generation  
10 capacity in the near term.”<sup>7</sup> (Panda Brief at p. 3) Panda believes that competitive procurement will  
11 benefit Arizona ratepayers with or without divestiture. Panda argues that “[e]ven leaving aside  
12 replacement of inefficient or environmentally undesirable generation owned by APS today, APS  
13 needs significant additional generation to meet its needs in the future. APS should not be allowed to  
14 meet these needs without a reasonable market test to determine whether its arrangements for doing so  
15 are in the public interest. Specifically, the new RedHawk and West Phoenix plants built by APS’  
16 merchant generation affiliate must be subject to challenge through competitive procurement to assure  
17 Arizona ratepayers are getting the best deal in terms of price, risk, and reliability. Neither of these  
18 plants has gone through prudence review and neither is in rate base.” (Panda Brief at p. 4)

19 Panda believes that the concerns about divestiture raised by other parties can be addressed  
20 through a competitive bidding framework and an appropriate prudence review, but if the “above-  
21 market, self-dealing PPA is the only way to mitigate the market power of APS affiliates, then the  
22 Commission should reject divestiture.” (Panda Brief at p.8).

21 **Reliant**

22 Reliant believes that allowing divestiture without appropriate competitive solicitation  
23 procedures in place and underway will “severely jeopardize the long-term viability of competition  
24 among wholesale suppliers in Arizona” and “places at risk the long-term viability of the existing and  
25 new generation projects constructed to serve the region’s electrical demand.” (Reliant Brief at pp. 7  
26

27 <sup>7</sup> According to Panda, APS’ projected summer 2003 load is approximately 6,000 MW and by that time or soon thereafter,  
28 6,500 MW of new competitive supply will be on-line in the APS service territory, for a total of 12,500 MW of capacity  
potentially competing to serve 6,000 MW of load. (Panda Brief at p. 3)

1 & 9) Reliant believes that by requesting a variance to 1606(B), APS effectively “stagnates the  
2 wholesale market in Arizona.” (Reliant Brief at p. 10)

### 3 AECC

4 AECC recommends that the Commission should “direct the parties to the APS and TEP  
5 settlement agreements (and other parties of interest) to make a prompt, good faith effort to address  
6 the following issues within the framework of the settlement agreements:

7 (a) timing of divestiture – the parties should consider the need to modify the timing of  
8 divestiture, as necessary, to comport with the Track B findings, (e.g., in the event that  
9 competitive bidding is delayed, then divestiture may be delayed); alternatively, APS can  
10 bring forward, for the consideration of the other parties and the Commission, a power  
11 purchase agreement that provides a short-term ‘bridge’ through 2003, to the extent such a  
12 product is needed to supplement APS’ standard offer requirements in light of Track B  
13 findings;

14 (b) longer-term power purchase agreement – APS can bring forward, for the consideration of  
15 the other parties and the Commission, a power purchase agreement that provides long-  
16 term resources using today’s rate-based generation as part of a portfolio that is limited to  
17 meeting demand *beyond* the standard offer requirements that are competitively bid (as  
18 determined in Track B).” (AECC Brief at pp. 3-4).

### 19 AUIA

20 AUIA believes that the Commission can safely allow APS to transfer its assets to PWEC and  
21 conduct a competitive solicitation within the limits imposed by the marketplace, or in the alternative,  
22 the Commission can examine the PPA concept proposed by APS. AUIA states that if none of these  
23 options are acceptable, the Commission should suspend the electric competition rules and continue  
24 cost-of-service regulation until it has completed a re-examination of electric competition in Arizona.  
25 AUIA believes that the “Commission has a legal and moral obligation to abide by the terms of the  
26 1999 Settlement Agreement it entered into with APS, absent a demonstration that extraordinary  
27 circumstances have intervened since then.” (AUIA Brief at p. 6) AUIA believes that there has been  
28 no such showing in this proceeding.

### 29 Sempra/SWPG

30 Sempra and SWPG argue that because Rule 1606(B) and 1615 are “intrinsically interwoven”,  
31 and because of market power concerns, the Commission should “establish as a fundamental principle  
32 that generation asset transfers will not be allowed to occur under Rule 1615 until the competitive  
33

1 procurement process contemplated by and provided for under Rule 1606(B) has been implemented.”  
 2 (Sempra/SWPG Brief at p. 4). Sempra/SWPG define “implemented” to include: “(i) contracts for the  
 3 provision of electric power have been awarded by UDCs pursuant to a Commission – approved  
 4 competitive procurement process, (ii) the results of that process have been publicly announced and  
 5 Commission.” (Sempra/SWPG Brief at p. 4)

6 Sempra/SWPG believes that it is premature to alter the deadlines for the asset transfers and  
 7 competitive power procurement because they believe that a viable competitive procurement process  
 8 may still be put in place by January 1, 2003; that APS and TEP could both still complete asset  
 9 transfers prior to January 1, 2003; and that market power studies could be completed, evaluated and  
 10 used constructively before the end of the year. Sempra/SWPG believe that asset transfer and  
 11 implementation of competitive procurement could be phased in, to the extent, and when market  
 12 power problems do not exist.

### 12 Harquahala

13 Harquahala believes that contracting for competitive procurement should occur prior to  
 14 divestiture and that it should not include existing network transmission service rights.

### 15 RUCO

RUCO recommends:

- 16 1. Until the Commission is assured that FERC is adequately overseeing Arizona’s wholesale  
 17 electric market, the Commission should suspend the divestiture requirement.
- 18 2. Once the Commission is confident that the wholesale market is workable and free of  
 19 market power pricing, divestiture should be accompanied by purchase power agreements  
 20 that assure Standard Offer customers have access to electricity at cost-based prices.
- 21 3. If the Commission decides to allow divestiture without a PPA in place, it should delay  
 22 divestiture for at least a year to conduct further study, including strategic behavior  
 23 modeling, to accurately assess market conditions.
- 24 4. The Commission must balance the need for further study with the costs.

### 25 ISSUE # 3 CODE OF CONDUCT/AFFILIATE TRANSACTIONS

#### 26 Staff

27 On the issues of Code of Conduct and Affiliate Relationships, Staff recommends:  
 28

- 1 1. Any investor-owned utility that wants to purchase power from an affiliate within twelve  
2 months of a Commission decision in this docket must file a Code of Conduct for  
3 Commission approval within ninety days of a Commission decision in this docket.
- 4 2. Any investor-owned utility that has already purchased power from an affiliate must file a  
5 Code of Conduct for Commission approval within ninety days of a Commission decision  
6 in this docket.
- 7 3. Any investor-owned utility that has not made a filing in response to #s 1 & 2 above but in  
8 the future plans to purchase power from an affiliate must obtain Commission approval of  
9 a Code of Conduct before executing any affiliate transactions.
- 10 4. Prior to a transfer of generation assets to an affiliate, an investor-owned utility must file a  
11 code of conduct for Commission approval unless such Code of Conduct has already been  
12 filed in response to recommendations #s 1, 2, or 3 above.
- 13 5. The Commission should adopt a Code of Conduct to fill the gaps among existing Codes of  
14 Conduct.

**APS**

15 On the issue of Code of Conduct/Affiliate Transactions, APS argues that it already has both a  
16 Commission-approved Code of Conduct and Policies and Procedures to effectuate the Code, and  
17 FERC-imposed Standards of Conduct, in addition to the affiliated interest rules, and that nothing is  
18 "broken" and in need of "fixing". However, APS states that if divestiture is permitted in accordance  
19 with the Settlement Agreement, APS would be willing to submit a revised Code of Conduct covering  
20 PWEC, PWM&T, and APS Energy Services. APS believes that divestiture should not be held up  
21 pending Commission consideration and approval of any amended Code of Conduct.

**Panda**

22 Panda believes that the "existing Code of Conduct and Affiliate Interest Rules do not  
23 adequately address problems of self-dealing, preferential treatment of affiliates and cross-  
24 subsidization of competitive services." (Panda Brief at p. 32) Panda agrees with Staff that "before  
25 divesting generation or transacting with an affiliate in any way, a UDC should be required to file with  
26 the Commission a proposed Code of Conduct that mitigates any potential for conflicts of interest,  
27 affiliate abuse, self-dealing or cross-subsidization, and which strictly limits access to commercially  
28 sensitive or confidential information." (Id. at 32) Further, Panda believes that notice should be  
provided to interested parties and an opportunity to comment on such a Code of Conduct should be

1 provided, with a complaint process before the Commission if a UDC or any of its affiliates violates  
2 the Code of Conduct.

3 **Reliant**

4 Reliant agrees with Staff that further consideration of Codes of Conduct is appropriate to  
5 ensure that ratepayers do not subsidize non-regulated competitive operations, but that it should not  
6 cause a material delay in the competitive procurement of Standard Offer load.

7 **Sempra/SWPG**

8 Sempra/SWPG support Staff's recommendation on adopting additional Code of Conduct  
9 requirements, but suggest that the Commission hold public hearings and/or an oral and written  
10 comment procedure on the Codes of Conduct filed in response to Staff's recommendations, and that  
11 such Codes of Conduct be in place by January 1, 2003.

12 **ISSUE #4 JURISDICTIONAL ISSUES**

13 **Staff**

14 On the Jurisdictional/Legal issues, Staff made the following recommendations:

- 15 1. If an asset transfer occurs, the Commission will lose its ratemaking jurisdiction over those  
16 assets and will have no jurisdiction over any power purchase agreement that occurs after  
17 the transfer of assets.
- 18 2. Once an asset transfer occurs, APS' acquisition of power would be wholesale transactions  
19 under the jurisdiction of the FERC.
- 20 3. The FERC has jurisdiction over both profit and not-for-profit RTOs.
- 21 4. The Commission is not contractually bound by the APS Settlement Agreement

22 **APS**

23 On the issue of jurisdiction of the Commission, APS asserts that the Commission will not lose  
24 any meaningful jurisdiction over the setting of retail rates as a result of generation divestiture. APS  
25 states that "[s]tate regulators have never had jurisdiction over most wholesale transactions." (APS  
26 Brief at p. 28) APS states that just as the Commission could not "deny rate recovery to a prudently  
27 acquired and operated resource that is used and useful in providing service" to a vertically integrated  
28 electric utility, the "Commission cannot deny rate recovery of a prudently acquired and administered  
purchase power expense that is used and useful in providing service to the Company's customers."  
(APS Brief at p. 29) APS states that the Commission's jurisdiction is not affected by the formation  
of or participation in a "for profit" RTO.

**TEP**

1 On the jurisdictional issue, TEP states that it is unaware of any jurisdictional impact  
2 attributable to the "for-profit" status of WestConnect.

**Panda**

3  
4 Panda argues that with divestiture, the Commission will not lose jurisdiction over "the most  
5 important aspect of its mandate: what APS' Standard Offer Service customers pay for APS purchases  
6 from its affiliate and other merchant generators for the capacity necessary to supply Standard Offer  
7 customers." (Panda Brief at p. 31) Panda recommends that the "Commission can and should  
8 condition any divestiture . . . on APS' agreeing to a market test prudence standard." (Id.) Panda  
9 further believes that the Commission will maintain substantial jurisdiction by its control of the  
10 competitive procurement process. Panda believes that the issue of for-profit or not-for profit RTO  
11 form does not affect the Commission's jurisdiction.

**MISCELLANEOUS ISSUES****Transmission**

12 On the issue of Transmission, Staff recommends:  
13

- 14 1. The Commission should encourage an industry-wide collaborative planning process to  
15 resolve transmission constraints (Smith Direct, Ex. S-13 at 25)
- 16 2. Staff recommends that the Commission initiate an appropriate proceeding to consider the  
17 adoption of the following standards:
  - 18 a. There should be sufficient transmission import capability to reliably serve  
19 all loads in a utility's service area without limiting consumer access or  
20 benefit to more economical or less polluting generation located external to  
21 the service area.
  - 22 b. A power plant must have sufficient interconnected transmission capacity to  
23 reliably deliver its full output without use of remedial action schemes for  
24 single contingency (N-1) outages or displacing a priori generation  
25 interconnected at the same switchyard or on the same transmission lines.
- 26 3. The Commission should order jurisdictional utilities to resolve RMR generation concerns.  
27 Specifically, the utilities should be ordered to:
  - 28 a. perform a study within thirty days of a Commission decision in Track A  
analyzing the merits of existing dependence on RMR generation instead of  
building transmission to resolve local transmission import reliability  
constraints;
  - b. perform a study analyzing the merits of any future contemplated utilization  
of RMR to defer transmission projects; and
  - c. file such RMR study reports with the Commission for review within thirty  
days of their completion and prior to implementing any new RMR  
generation strategies.

- 1 4. Staff recommends that the Commission should consider appropriate avenues to establish  
2 the following criteria:
- 3 a. Future power plant applications for CECs should be denied for sufficiency  
4 purposes if they have not fulfilled the statutory technical study  
5 requirements demonstrating the impact of the project on the existing  
6 Arizona transmission system; and
  - 7 b. Power plants that fail to demonstrate the ability to reliably deliver to a  
8 market without displacing a priori generation interconnected at the same  
9 location or utilizing the same interconnected transmission system should  
10 not be granted a CEC.
- 11 5. Both transmission providers and merchant power plants should share the burden and  
12 obligation to resolve Arizona's transmission constraints.

13 In response to Staff's recommendation, APS states that the Commission should continue to  
14 monitor transmission issues and complete the next Biennial Transmission Assessment. APS and  
15 Staff agree that successful transmission planning will require collaboration with all affected parties,  
16 including parties not subject to the Commission's regulatory jurisdiction. APS believes that there are  
17 no "must run" or transmission market power issues that should affect the timing of divestiture.

#### 18 PWEC's generation

19 APS added an additional issue: termed the "West Phoenix and Redhawk" issue. APS states  
20 that although the West Phoenix Power Plant Expansion and Redhawk Power Units 1 and 2 are being  
21 constructed by PWEC and are therefore "merchant plants", they are being built to meet the reliability  
22 needs of APS' Standard Offer customers.

23 APS also wants the Commission to address what it calls the "bifurcation issue" and states that  
24 the Commission should allow APS and its affiliates to recover all costs incurred in reliance on the  
25 provisions of the APS Settlement. Specifically, APS believes that the Commission should: "indicate  
26 that APS is entitled to recover all reasonable incurred and increased costs occasioned by the  
27 Commission's change in position" (including costs of its affiliates); allow "APS to acquire and  
28 finance the Dedicated Units presently owned by PWEC"; reconsider other aspects of the APS  
Settlement during the Company's next rate proceeding or in a separate proceeding held prior to the  
next rate case, including how to restore the "\$234 million write-off" and "the one-third of divestiture-  
related costs the Company was forced to absorb under Decision No. 61973." (APS Brief at pp. 42-  
43.)

Panda believes that APS introduced significant testimony going well beyond the identified  
Track A issues, mainly that the "PWEC merchant facilities were constructed 'for the benefit of APS

1 customers.' Tr. At 130". Panda believes that whether PWEC's merchant facilities (RedHawk 1 & 2  
2 and West Phoenix 4 & 5) should be transferred to APS is not before the Commission at this time.

3 Panda notes that while APS presented evidence of steps it took to divest in reliance on the  
4 Settlement Agreement, there is nothing in the record of any reasonable, timely efforts to comply with  
5 the requirement to competitively procure power for its Standard Offer customers. Specifically, Panda  
6 states that there is "no evidence that APS ever issued an RFP, made a competitive solicitation on any  
7 significant scale for any period following entry of the APS Settlement Agreement, circulated its long-  
8 term energy or capacity requirements to any party, other than its merchant affiliate, to allow the  
9 market to be responsive to those needs, or otherwise sought a competitive alternative to its affiliate's  
10 construction projects. . . .In fact, the testimony in this proceeding demonstrated that APS is relying on  
11 affiliate transactions to supply needs in 2002, again without any apparent effort to solicit those needs  
12 from the competitive market." (Panda Brief at p. 6)

13 In a footnote in its brief, Reliant states that PWEC must not be allowed to transfer RedHawk  
14 and West Phoenix to APS if divestiture does not occur, as these were built as competitive assets.  
15 According to Reliant, "[a]ny non-competitive transfer to APS will effectively eliminate the  
16 possibility of creating a robust competitive wholesale market, and the benefits to retail customers . . .  
17 ." (Reliant brief at p. 10)

### 18 Retail Competition

19 TEP proposed that if retail electric competition is to proceed at this time, the Commission  
20 should allow only customers with a load of 3 MW or more direct access for now.

21 AES NE/Strategic discussed only one issue in their brief: TEP's proposal to deny retail  
22 customer choice to all of Arizona's residential customers and to commercial and industrial customers  
23 with load requirements of less than 3 MW.

24 AES NE/Strategic believe that TEP's proposal is a fundamental breach of its Settlement  
25 Agreement. According to AES NE/Strategic, retail choice was a fundamental and significant element  
26 of the settlement; TEP seeks to preserve its own benefits gained under the Settlement while denying a  
27 fundamental benefit achieved by other parties to the Settlement; and TEP has failed to comply with  
28 its obligations to defend the Amended Settlement Agreement and has taken actions that are  
inconsistent with its provisions.

AES NE/Strategic notes that TEP did not make any effort to discuss the issue or consult with  
other parties to the Settlement Agreement, but made a unilateral proposal in its testimony in this  
proceeding. AES NE/Strategic also argues that TEP's efforts to declare competition dead ignores

1 TEP's own role in forestalling competition, citing as the primary reason why direct access customers  
2 returned to bundled service with TEP, the failure of TEP to pay the required competitive transition  
charge to direct access customers when market prices spiked in the west.

3 AES NE/Strategic believes that if the Commission were to "accept TEP's anti-competitive  
4 proposal, the end result for retail competition in Arizona would be the same as if the Commission  
5 acted to repeal the Retail Electric Competition Rules adopted in September 1999 – it would be the  
6 death knell to retail competition in Arizona." (AES NE/Strategic Brief at p. 11)

7 AECC criticized TEP and RUCO for introducing into the record proposed changes to  
8 Arizona's retail direct access program, which are outside the scope of this Track A proceeding.  
9 AECC strongly objects to the proposed changes, and views TEP's proposal as a "bad faith attempt to  
10 advance its pre-settlement agreement objectives." (AECC Brief at p. 2) Accordingly, AECC did not  
brief the issue, but reserved its right to argue against the positions advanced in the appropriate forum.

11 RUCO's witness testified that TEP's recommendation that only customers with loads of 3  
12 MW or greater be allowed to participate in retail competition is a reasonable option to consider, if  
13 traditional cost-of-service bundled retail rates are maintained for all other customers, and if  
14 divestiture does not occur.

### 15 ANALYSIS

#### 16 Market Power

17 All the parties to the proceeding, with the exception of APS and AUIA, agree that market  
18 power/market abuse issues are real and should be addressed. We find that APS and TEP have market  
19 power today in their Phoenix Valley, Yuma and Tucson load pockets, respectively. Moreover, we  
20 note that there is no RTO currently in existence in Arizona and believe that it is desirable to establish  
21 a process that builds upon, but goes beyond, the Arizona ISA "must-run generation" protocol to  
22 evaluate the long-term infrastructure needs of service to load pockets. We disagree that market  
23 power in the load pockets is best addressed through sole reliance on the "must-run generation"  
24 protocol of the Arizona ISA. We believe that it is appropriate to conduct market power studies that  
25 focus not only on regional market power, but on how market power can be exercised in Arizona  
26 specific areas, and how it can best be mitigated. Although Reliant posed an interesting concept to  
27 mitigate market power through a supply auction, we are not convinced that such a process is  
workable or appropriate in Arizona at this time. Accordingly, we adopt Staff's recommendations and  
will require APS and TEP to produce market power studies accompanied by market mitigation plans

1 before allowing them to divest. Further, we agree with AECC and RUCO that the parties should seek  
2 a consensus approach to market power testing, monitoring, and mitigation.

3 Our findings about market power are intended to be used for purposes of this proceeding only  
4 as they relate to the issue of asset divestiture. We are not making any finding regarding any FERC  
5 determination of market power, and our findings about market power are not intended to be used in  
6 any FERC proceeding or in another forum.

### 6 Divestiture

7 In retrospect, it was a good idea to delay divestiture and competitive procurement in the APS  
8 and TEP Settlement Agreements, given what has happened in the last two or so years, including the  
9 experience in California; the market volatility and illiquidity; and the lack of public confidence in the  
10 transition to electric deregulation and ability of regulators to prevent price spikes, ensure reliable  
11 service, and prevent bankruptcies. Even today, there is not agreement amongst economists, much  
12 less regulators, as to why and what happened in California, happened, and how to prevent a similar or  
13 related occurrence.

14 It is clear that the Commission and all parties expected benefits from retail competition, yet  
15 there is no active retail competition, so actual benefits are still unknown. It is said that consumers  
16 will benefit from wholesale competition, but not without the proper market structure and regulatory  
17 framework that will support it. It was anticipated that at the time that APS and TEP divested, ESPs  
18 would be providing direct access to retail customers. In actuality, no retail competition exists; market  
19 power is held by the incumbent utilities; no RTO is in effect; transmission constraints exist that  
20 potentially exacerbate market abuse; the GAO has issued a negative report on FERC's ability to  
21 manage competitive markets; both TEP and APS recognize a problem – one wants to postpone its  
22 divestiture while the other is affected by its parent's and affiliates' adverse financial considerations;  
23 proposed new generation may be cancelled if it is not able to find a market; more protections are  
24 needed against self-dealing and inappropriate affiliate transactions; and investigations are ongoing  
25 into market manipulations and improprieties. Contrary to what APS argues, these changes relate to  
26 the question of divestiture, especially to our willingness to transfer our ratemaking jurisdiction over  
27 generation assets to FERC, given its recent history regulating the wholesale market and the  
28 conclusions contained in the recent GAO report.

29 We find that due to circumstances outside our control or the control of any party, and in order  
30 to protect the public interest, we must take further action to regulate the transition to competition. We  
31 want to take action in a manner that is fair to all parties and that protects ratepayers. Neither the  
32

1 Commission nor any party to this proceeding anticipated the current state of electric competition nor  
 2 caused the problems that have been identified. Therefore, the wise course of action is to try to  
 3 minimize the effects and figure out a way to move forward that will ultimately result in a market  
 4 structure that performs efficiently and rationally, and that will result in the benefits that were  
 5 promoted in the move to competition. As a constitutionally created state agency, our overriding  
 6 concern is the public interest. This means maintaining the ability, through our jurisdiction, to insure  
 7 that Arizona ratepayers receive reliable, safe, economic, and efficient electric power.

8 Therefore, we find that the public interest requires that the divestiture requirement found in  
 9 A.A.C. R14-2-1615(A) and our extensions of that requirement until January 1, 2003, found in  
 10 Decision Nos. 61973 and 62103, must be modified in the following manner: TEP is granted a waiver  
 11 of A.A.C. R14-2-1615(A); APS is granted a waiver of A.A.C. R14-2-1615(A); and both companies  
 12 are hereby directed to cancel any plans to divest interests in any generating assets. Should either  
 13 company wish to pursue the divestiture outlined in R14-2-1615(A) in the future, they should file  
 14 applications to that effect for Commission consideration. This determination is consistent with our  
 15 planned transition to competition and as we said in Decision No. 61973, “. . . the Commission must  
 16 be able to make rule changes/other future modifications that become necessary over time.” (Decision  
 17 No. 61973 at p. 9) As we also said in Decision No. 61973, it is “not the Commission’s intent to  
 18 undermine the benefits that parties have bargained for.” (Id.) Recognizing this, it is incumbent upon  
 19 all parties to work together in such a manner that will allow competition and its expected benefits to  
 20 develop in whatever timeframe is needed to make it successful, while ensuring that the citizens of  
 21 Arizona have safe, reliable and fairly priced electric power. Accordingly, we will modify Decision  
 22 Nos. 61973 and 62103 to stay the asset transfer provisions as outlined above.

23 Further, we will modify R14-2-1606(B) and Decision Nos. 61973 and 62103’s requirement  
 24 that 100 percent of power purchased for Standard Offer Service shall be acquired from the  
 25 competitive market, with at least 50 percent through a competitive bid process; but effective upon  
 26 implementation of the outcome of Track B, we will require APS and TEP to acquire, at a minimum<sup>8</sup>,  
 27 any required power that cannot be produced from its own existing assets, through the competitive  
 28 procurement process as developed in the Track B proceeding.<sup>9</sup> The amount of power, the timing, and  
 the form of procurement shall be determined in the Track B proceeding. We believe that in this way  
 we can encourage a phase-in to competition, encourage the development of a robust wholesale

<sup>8</sup> APS and TEP may decide to retire or displace inefficient, uneconomic, environmentally undesirable plants.

<sup>9</sup> The Commission will closely monitor APS’ and TEP’s power procurement for potential affiliate concerns until the Track B competitive procurement process is implemented.

1 market for generation, and obtain some of the benefits of the new Arizona generation resources,  
2 while at the same time protecting ratepayers.

3 The waivers and actions ordered herein should allow the market power issue and any  
4 necessary future market power studies to be performed and recommendations made; allow FERC to  
5 gain experience and expertise in regulating competitive wholesale markets; increase the supply of  
6 new generation; allow for necessary revisions to the Electric Competition Rules; allow the  
7 development of an effective RTO or other such entity; allow for some transmission constraints to be  
8 resolved; allow the Commission, APS, TEP, and the parties to develop and implement a phased-in  
9 competitive procurement process; and allow all participants to analyze and learn from the events that  
10 have occurred during the past two years. We agree with TEP that the overriding concern of the  
11 Commission must continue to be “ensuring that the citizens of Arizona have safe, reliable and fairly  
12 priced electric power”.

13 APS’ request for a change to the competitive procurement requirement of 1606(B) is no  
14 different than a request for a change to the requirement of divestiture in 1615(A).<sup>10</sup> Although APS  
15 tries to argue that the Commission can modify one provision (1606(B)) but not the other provision  
16 (1615(A)), the two provisions have always been paired together. Even APS witness Jack Davis  
17 testified to their linkage. When asked whether divestiture and competitive bidding under Rule  
18 1606(B) are linked, he responds: “Absolutely, both in the historical context of the Electric  
19 Competition Rules and in the practical sense . . . Even during the approval process of the 1999 APS  
20 Settlement Agreement, the variance granted to Rule 1606(B) was referred to as a ‘corresponding  
21 delay,’ that is, ‘corresponding’ to the delay in implementation of Rule 1615.” (Davis Direct at pp. 9-  
22 10)

23 Both were treated the same in Decision No. 61973 – granted “two-year extensions”, therefore,  
24 if granting a “variance” from 1606(B) would not violate the Settlement Agreement, then granting a  
25 “stay” or “variance” of 1615(A) would similarly not violate the Settlement Agreement. To the extent  
26 that any party believes that such a variance to 1615(A) is a violation of the Settlement Agreement, the  
27 Commission once again<sup>11</sup> urges the parties to meet and work to resolve the issue. Even if we were to  
28

<sup>10</sup> Although upon redirect examination, Mr. Davis testified that neither the decision approving the settlement nor the addendum filed on December 1, 1999 in accordance with the Commission’s order mentioned 1606(B), the Variance/PPA application at page 5 states “Decision No. 61973 provided : ‘[A] similar two-year extension shall be authorized for compliance with A.A.C. R14-2-1606(B).’ *Id.* at 9.”, which quote is also found in the addendum at page 3, in paragraph 5, as set forth in 4.1(1).

<sup>11</sup> See February 8, 2002 Procedural Order at page 8, lines 22-23.

1 believe that granting a stay or variance of the divestiture requirement would necessitate modification  
2 of the Settlement Agreement, the public interest requires such action.

3 **Code of Conduct/Affiliated Interest**

4 We agree with Staff that the Codes of Conduct we have already approved need additional  
5 provisions and should cover an investor-owned electric utility regulated by the Commission and all  
6 affiliates in energy-related fields, including affiliates who sell power. The Commission has an  
7 interest in and jurisdiction over affiliate wholesale purchases used to serve Arizona retail customers.  
8 At a minimum, the Code of Conduct should address the items identified by Staff, including: arm's  
9 length transactions; access to confidential information; cross-subsidization; preferential treatment to  
10 affiliates; joint employment and employee transfer issues; sharing of office space, equipment, and  
11 services; proprietary customer information; financing arrangements with affiliates; and conflicts of  
12 interest. Accordingly, we will require APS and TEP to submit modifications as suggested by Staff to  
13 their Codes of Conduct as adopted in Decision No. 62416 (April 3, 2000) and Decision No. 62767  
14 (August 2, 2000). Such proposed revisions shall be filed with the Commission and provided to any  
15 requesting party, with a hearing to be held as provided in R14-2-1616. Regarding Panda's request for  
16 a complaint procedure, we note that 1616(B)(9) currently provides for a complaint process.

15 **Jurisdictional Issues**

16 The parties are in agreement that once an asset transfer occurs, APS' acquisition of power would  
17 be wholesale transactions under the jurisdiction of the FERC and that FERC has jurisdiction over  
18 both profit and not-for-profit RTOs. The parties agree that the Commission's jurisdiction over public  
19 service corporations is unaffected whether an RTO approved by FERC is for-profit or not-for-profit.

19 **Miscellaneous Issues**

20 We agree with Staff's recommendation to form an Electric Competition Advisory Group.  
21 This will facilitate communication and information sharing among Staff, stakeholders, and market  
22 participants. Additionally, we believe that Staff should prepare and file quarterly reports detailing the  
23 activities of the Advisory Group.

24 We are in general agreement with the Staff recommendations on transmission issues, and we  
25 encourage an industry-wide planning process to resolve transmission constraints. We believe that  
26 both transmission providers and merchant power plants should share the burden and obligation to  
27 resolve Arizona's transmission constraints. Further, we will order APS and TEP to work with Staff  
28 to develop a 2002 study process to resolve RMR generation concerns, such study plan results to be  
included in the 2004 Biennial Transmission Assessment. This would include studying and analyzing

1 the merits of existing dependence on RMR generation instead of building transmission to resolve  
2 transmission import reliability constraints and the merits of any future contemplated utilization of  
3 RMR to defer transmission projects. Until the 2004 Biennial Transmission Assessment is issued with  
4 RMR study plan results resolved, APS and TEP shall file annual RMR study reports with the  
5 Commission in concert with their January 31 annual ten year plan for review prior to implementing  
6 any new RMR generation strategies.

7 We recognize that APS has asserted that the generation units owned and built by its affiliate,  
8 PWEC, should be acquired by APS. This issue is not the subject of this Track A proceeding, and  
9 there is not sufficient evidence on the record to make a finding thereon, nor have parties had an  
10 opportunity to present evidence on the issue. If APS wishes to pursue this issue, it should file the  
11 appropriate application(s) by September 15, 2002. The results of the proceeding on such application  
12 shall not affect the amount, timing, and manner of the competitive procurement process. This  
13 proceeding should not address the ratemaking treatment of these assets. In authorizing this  
14 proceeding, we are not predetermining the relative merits of the issues to be addressed. Once an  
15 Application is filed, the Hearing Division shall promptly issue a Procedural Order scheduling a  
16 procedural conference to discuss the scope of the proceeding.

17 Although TEP made a recommendation concerning changing the availability of Retail  
18 Competition, this was not an issue the Commissioners agreed to be decided in Track A, and there is  
19 insufficient evidence in the record to make a determination on this issue. Accordingly, we will not  
20 modify the direct access provisions of the Retail Electric Competition Rules at this time.

21 Staff recommends that the following Rules and/or Decisions may need to be stayed/amended:  
22 A.A.C. R14-2-1606(B); A.A.C. R14-2-1611(A); A.A.C. R14-2-1615(A); Decision No. 61973 (APS  
23 Settlement); and Decision No. 62103 (TEP Settlement).

24 APS essentially argues that it does not recommend any changes, but that if divestiture is not  
25 allowed, it recommends a comprehensive review of all Electric Competition Rules to determine if  
26 other rules are also implicated, and also with other Commission decisions, such as Decision No.  
27 62416 which approved APS' Code of Conduct but also prohibited APS from providing competitive  
28 generation.

As contained in the discussions above, we have granted a waiver of A.A.C. R14-2-1615(A) and  
found that A.A.C. R14-2-1606(B) and A.A.C. R14-2-1611(A) as applied to TEP and APS' captive  
customers, should be stayed, and Decision No. 61973 (APS Settlement); Decision No. 62103 (TEP  
Settlement); Decision No. 62416 (APS Code of Conduct) and Decision No. 62767 (TEP Code of

1 Conduct) should be modified as discussed herein. Further, we agree with APS that there should be a  
 2 comprehensive review of all Electric Competition Rules to determine if other rules or Commission  
 3 decisions are also implicated as a result of our determinations in Track A, and we also believe that  
 4 such a review and rulemaking may be appropriate at the conclusion of Track B. Accordingly, we will  
 5 direct Staff to open a rulemaking docket to address any required changes to rules, and will keep this  
 6 docket open for parties to file comments upon what other decisions/issues may need to be revisited.

7 \* \* \* \* \*

8 Having considered the entire record herein and being fully advised in the premises, the  
 9 Commission finds, concludes, and orders that:

10 **FINDINGS OF FACT**

11 1. On October 18, 2001, Arizona Public Service Company filed a Request for a Partial  
 12 Variance to A.A.C. R14-2-1606(B) and for Approval of a Purchase Power Agreement.

13 1. By Procedural Order issued January 22, 2002, the Commission opened this generic  
 14 docket on electric restructuring (Docket No. E-00000A-02-0051). The Commissioners, through a  
 15 series of letters, requested that the parties respond to questions about electric competition.

16 2. On January 28, 2002, Tucson Electric Power Company filed a Request for Variance  
 17 (Docket No. E-01933A-02-0069).

18 3. Intervention was granted to numerous parties.

19 4. On March 19, 2002, Panda Gila River, L.P. filed a Request for Order to Show Cause.

20 5. On March 22, 2002, Staff filed its Staff Report in the generic docket, summarizing the  
 21 parties' answers to the Commissioners' questions and making recommendations about electric  
 22 restructuring.

23 6. On April 22, 2002, APS filed a Motion for Determination of Threshold Issue, which  
 24 indicated that APS intended to submit its "30-day letter" regarding the asset transfer on  
 25 approximately August 1, 2002, irrespective of the Commission's resolution of the Variance/PPA  
 26 request or the proceedings in the generic electric docket.

27 7. On April 25, 2002, the Commission held a Special Open Meeting at which the  
 28 Commission stayed the APS Variance/PPA hearing, denied Panda's Request for an OSC, and  
 directed that certain issues be addressed in the Generic Docket.

8. By Procedural Order issued on May 2, 2002, a hearing was set on the issues identified  
 by the Commission, including: the transfer of assets and associated market power issues; Code of  
 Conduct; Affiliated Interest Rules; and jurisdictional issues raised by Chairman Mundell, collectively

1 referred to as "Track A" issues. Track B, Competitive Procurement, was also established.

2 9. The May 2, 2002 Procedural Order also put the parties and the general public on  
3 notice that the Commission may initiate rulemaking(s), or, pursuant to A.R.S. § 40-252, after hearing,  
4 enter such orders as may be appropriate relating to electric restructuring, including variances from  
5 Commission rules and/or Decisions.

6 10. Notice of the hearing was published in newspapers of general circulation in the APS  
7 and TEP service areas and statewide between May 26 and June 6, 2002.

8 11. The hearing was held as scheduled. No members of the public appeared to make  
9 public comment. Witnesses testified on behalf of APS, TEP, AUIA, AECC, RUCO, Panda,  
10 Harquahala, Sempra/SWPG, Reliant, AES NE/Strategic, and Staff.

11 12. By Procedural Order issued on July 10, 2002, TEP's application to amend its market  
12 generation credit was removed from this consolidated proceeding.

13 13. On July 10, 2002, the parties filed briefs.

14 14. The Commission has an interest in and jurisdiction over affiliate wholesale purchases  
15 used to serve Arizona retail customers.

16 15. Market power could unfairly impact retail prices after divestiture and after the  
17 termination of existing price caps.

18 16. The wholesale market applicable to Arizona is poorly structured and susceptible to  
19 possible malfunction and manipulation.

20 17. APS has market power in its Phoenix Valley and Yuma load pockets.

21 18. TEP has market power in its Tucson load pocket.

22 19. APS and TEP have market power today in their Phoenix Valley, Yuma and Tucson  
23 load pockets, respectively. Full divestiture of their generating assets would limit the jurisdictional  
24 ability of this Commission to ensure that such market power does not and will not exist in the future.  
25 Thus, we find that the provisions of A.A.C. R14-2-1615(A) requiring full divestiture are, at this time,  
26 not in the public interest.

27 20. APS and TEP's market power cannot be mitigated solely through reliance on  
28 competitive procurement at this time.

29 21. Our findings about market power are intended to be used for the purposes of this  
30 proceeding only as they relate to the issue of asset divestiture. We are not making any finding  
31 regarding any FERC determination of market power, and our findings about market power are not  
32 intended to be used in any FERC proceeding or in another forum.

1 22. Asset transfers should not be permitted unless the transfer will serve the public  
2 interest.

3 23. The waiver of the asset transfer requirements of A.A.C. R14-2-1615(A) serves the  
4 public interest and recognizes the current state of the wholesale market in Arizona.

5 24. Absent conditions in place to address market structure concerns, generation asset  
6 transfers as contemplated in prior Commission Decisions and A.A.C. R14-2-1616(A) are not in the  
7 public interest.

8 25. The wholesale market is not currently workably competitive; therefore, reliance on  
9 that market without recognizing its current uncertainty and limitations will not result in just and  
10 reasonable rates for captive customers.

11 26. The FERC has not yet defined or implemented an effective regulatory and oversight  
12 approach for competitive energy markets, so assurance is lacking that wholesale electricity prices are  
13 just and reasonable.

14 27. In order to transfer assets, a utility should file a market power study, a market  
15 mitigation plan, and revisions to its Code of Conduct.

16 28. At the time that the Commission approved the Electric Competition Rules and the  
17 Settlement Agreements, the parties thought that retail competition was imminent and that the  
18 wholesale market would be competitive; that a significant number of retail competitors would be  
19 entering the market; and that customers would leave the incumbent utility and purchase power from  
20 the new competitors.

21 29. Contrary to the parties' expectations and assumptions, the wholesale market has  
22 faltered, the new competitors have failed to materialize, and incumbent utilities have not lost  
23 customers in any meaningful number.

24 30. The competitive conditions that formed the basis of the Settlement Agreement and the  
25 adoption of the Retail Electric Competition Rules have not occurred as expected.

26 31. Competition and its benefits have not materialized for Arizona's small retail  
27 customers.

28 32. In its Variance/PPA application, APS concluded that adherence to the competitive  
bidding requirements of the Electric Competition Rules will not produce the intended result of  
reliable retail electric service for Standard Offer customers at reasonable rates.

33. The Codes of Conduct that we have already approved need additional provisions and  
should cover an investor-owned electric utility regulated by the Commission and all affiliates in

1 energy-related fields, including affiliates who sell power at wholesale.

2 34. APS and TEP shall submit modifications as recommended by Staff to their Codes of  
3 Conduct as adopted in Decision No. 62416 (April 3, 2000) and Decision No. 62767 (August 2, 2000).  
4 Such proposed revisions shall be filed with the Commission and provided to any requesting party,  
5 with a hearing to be held as provided in A.A.C. R14-2-1616.

6 35. A.A.C. R14-2-1615(A) should be waived and Decision Nos. 61973 and 62103 should  
7 be modified as directed herein.

8 36. A.A.C. R14-2-1606(B) should be stayed and Decision Nos. 61973 and 62103 should  
9 be modified to stay the requirement that 100 percent of power purchased for Standard Offer Service  
10 shall be acquired from the competitive market, with at least 50 percent through a competitive bid  
11 process; but effective upon implementation of the outcome of Track B, we will require APS and TEP  
12 to acquire, at a minimum, any required power that cannot be produced from its own existing assets,  
13 through the competitive procurement process as developed in the Track B proceeding. The amount  
14 of power, the timing, and the form of procurement shall be determined in the Track B proceeding.

15 37. We believe that requiring some power to be purchased through the competitive  
16 procurement process developed in Track B will encourage a phase-in to competition, encourage the  
17 development of a robust wholesale market for generation, and obtain some of the benefits of the new  
18 Arizona generation resources, while at the same time protecting ratepayers. We direct the parties to  
19 continue their efforts in Track B of this proceeding to develop a competitive solicitation process that  
20 can begin by March 1, 2003. For the purposes of the competitive procurement process, the PWEC  
21 generating assets that APS may seek to acquire from PWEC shall not be counted as APS assets in  
22 determining the amount, timing, and manner of the competitive procurement.

23 38. Staff's recommendation to form an Electric Competition Advisory Group is adopted,  
24 and Staff should prepare and file quarterly reports during the first two years following the effective  
25 date of this decision,<sup>12</sup> detailing the activities of the Advisory Group, with the first such report filed in  
26 January 2003 and detailing activities conducted during the third quarter of this year.

27 39. Both transmission providers and merchant power plants should share the burden and  
28 obligation to resolve Arizona's transmission constraints.

40. APS and TEP should work with Staff to develop a 2002 study process to resolve RMR  
generation concerns, such study plan results to be included in the 2004 Biennial Transmission  
Assessment. This includes studying and analyzing the merits of existing dependence on RMR

<sup>12</sup>After two years, the reports should be filed on a semi-annual basis.

1 generation instead of building transmission to resolve transmission import reliability constraints and  
 2 the merits of any future contemplated utilization of RMR to defer transmission projects.

3 41. Until the 2004 Biennial Transmission Assessment is issued with RMR study plan  
 4 results resolved, APS and TEP shall file annual RMR study reports with the Commission in concert  
 5 with their January 31 annual ten year plan for review prior to implementing any new RMR generation  
 6 strategies.

7 42. Nothing in the Retail Electric Competition Rules abrogates APS and TEP's  
 8 responsibility to provide reliable and reasonably priced service to their customers.

9 43. The issue of APS acquiring PWEC's generation assets is not the subject of this Track  
 10 A proceeding, and there is not sufficient evidence on the record to make a finding, nor have parties  
 11 had an opportunity to present evidence on the issue. If APS wishes to pursue this issue, it should file  
 12 the appropriate application(s) by September 15, 2002. The results of the proceeding on such  
 13 application shall not affect the amount, timing, and manner of the competitive procurement process.  
 14 This proceeding should not address the ratemaking treatment of these assets. In authorizing this  
 15 proceeding, we are not predetermining the relative merits of the issues to be addressed. Once an  
 16 Application is filed, the Hearing Division shall promptly issue a Procedural Order scheduling a  
 17 procedural conference to discuss the scope of the proceeding.

18 44. The continued availability of retail direct access is not an issue in this proceeding and  
 19 there is insufficient evidence in the record to make a determination on this issue.

20 45. The parties agree that the Commission's jurisdiction over public service corporations  
 21 is unaffected whether an RTO approved by FERC is for-profit or not-for profit.

22 46. It is incumbent upon all parties to work together in such a manner that will allow  
 23 competition and its expected benefits to develop in whatever timeframe is needed to make it  
 24 successful, while ensuring that the citizens of Arizona have safe, reliable and fairly priced electric  
 25 power.

### CONCLUSIONS OF LAW

26 1. The Commission has jurisdiction over these proceedings.

27 2. Notice of these proceedings was given as required by law.

28 3. Pursuant to Article 15, § 3 of the Arizona Constitution, the Commission has full power  
 to make and enforce reasonable rules, regulations, and orders for convenience, comfort, and safety  
 and the preservation of the health of the employees and patrons of public service corporations.

4. Pursuant to A.R.S. § 40-361, every public service corporation shall furnish and

1 maintain such service, equipment and facilities as will promote the safety, health, comfort and  
2 convenience of its patrons, employees and the public, and as will be in all respects adequate,  
3 efficient, and reasonable.

4 5. Pursuant to A.R.S. §§ 40-321 and 40-331, the Commission has broad authority to  
5 regulate the service and facilities of public service corporations in order to protect the public.

6 6. The evidence presented in this proceeding demonstrates that, at this time, pursuant to  
7 Article 15, §3 of the Arizona Constitution and A.R.S. §§ 40-361, -321, and -331, the public interest  
8 requires the suspension of the time deadline requirements of A.A.C. R14-2-1606(B), as amended by  
9 Decision Nos. 61973 and 62103, pending a Decision in these dockets on the Track B issues.

10 7. The evidence presented in this proceeding demonstrates that, at this time, pursuant to  
11 Article 15, §3 of the Arizona Constitution and A.R.S. §§ 40-361, -321, and -331, the public interest  
12 requires the waiver of A.A.C. R14-2-1615(A), as amended by Decision Nos. 61973 and 62103, and  
13 further, to prohibit the transfer of generation assets.

14 8. The evidence presented in this proceeding demonstrates that, at this time, pursuant to  
15 Article 15, §3 of the Arizona Constitution and A.R.S. §§ 40-361 the public interest requires the  
16 suspension of A.A.C. R14-2-1611(A)'s applicability to APS and TEP's captive customers.

17 9. The Codes of Conduct as adopted in Decision No. 62416 (April 3, 2000) and Decision  
18 No. 62767 (August 2, 2000) must be revised in order to protect the public interest.

19 10. A rulemaking proceeding to review the Retail Electric Competition Rules in light of  
20 our decisions herein and to address issues resolved in Track B, and to amend A.A.C. R14-2-1615(A),  
21 A.A.C. R14-2-1606(B), and A.A.C. R14-2-1611(A) should be initiated immediately.

22 11. The Commission's jurisdiction over public service corporations is unaffected by  
23 whether such public service corporations participate in a for-profit or not-for profit RTO.

24 12. Our findings about market power are intended to be used for purposes of this  
25 proceeding only as they relate to the issue of asset divestiture. We are not making any finding  
26 regarding any FERC determination of market power, and our findings about market power are not  
27 intended to be used in any FERC proceeding or in another forum.

### 28 **ORDER**

IT IS THEREFORE ORDERED that Tucson Electric Power Company and Arizona Public  
Service Company are granted waivers of A.A.C. R14-2-1615(A), Decision Nos. 61973 and 62103 are  
modified as discussed herein, and both companies are hereby ordered to cancel any plans to divest  
interests in any generating assets.

1 IT IS FURTHER ORDERED that A.A.C. R14-2-1606(B) is stayed and Decision Nos. 61973  
2 and 62103 are modified to stay the requirement that 100 percent of power purchased for Standard  
3 Offer Service shall be acquired from the competitive market, with at least 50 percent through a  
4 competitive bid process.

5 IT IS FURTHER ORDERED that A.A.C. R14-2-1611(A)'s applicability to APS and TEP's  
6 captive customers is stayed.

7 IT IS FURTHER ORDERED that upon implementation of the outcome of Track B, APS shall  
8 acquire, at a minimum, any required power that cannot be produced from its own existing assets,  
9 through the competitive procurement process as developed in the Track B proceeding. The minimum  
10 amount of power, the timing, and the form of procurement shall be determined in the Track B  
11 proceeding.

12 IT IS FURTHER ORDERED that upon implementation of the outcome of Track B, TEP shall  
13 acquire, at a minimum, any required power that cannot be produced from its own existing assets,  
14 through the competitive procurement process as developed in the Track B proceeding. The minimum  
15 amount of power, the timing, and the form of procurement shall be determined in the Track B  
16 proceeding.

17 IT IS FURTHER ORDERED that the parties are directed to continue their efforts in Track B  
18 of this proceeding to develop a competitive solicitation process that can begin by March 1, 2003. For  
19 the purposes of the competitive solicitation process, the PWEC generating assets that APS may seek  
20 to acquire from PWEC, shall not be counted as APS assets in determining the amount, timing and  
21 manner of the competitive solicitation.

22 IT IS FURTHER ORDERED that Staff shall open a rulemaking to review the Retail Electric  
23 Competition Rules in light of our decisions herein and to address issues resolved in Track B, and to  
24 amend A.A.C. R14-2-1615(A), A.A.C. R14-2-1606(B), and A.A.C. R14-2-1611(A).

25 IT IS FURTHER ORDERED that APS and TEP shall work with Staff to develop a plan as  
26 discussed herein to resolve reliability must-run generation concerns. Staff shall include results of  
27 such a plan in the 2004 Biennial Transmission Assessment.

28 IT IS FURTHER ORDERED that APS and TEP shall file annual reliability must-run  
generation study reports with the Commission in concert with their January 31 ten year plan, for  
review prior to implementing any new RMR generation strategies until the 2004 Biennial  
Transmission Assessment is issued.

IT IS FURTHER ORDERED that if APS wishes to pursue the issue of acquiring PWEC's

1 generation assets, it shall file the appropriate application(s) by September 15, 2002. The results of  
2 the proceeding on such application shall not affect the amount, timing, and manner of the competitive  
3 procurement process. This proceeding should not address the ratemaking treatment of these assets.  
4 In authorizing this proceeding, we are not predetermining the relative merits of the issues to be  
5 addressed. Once an Application is filed, the Hearing Division shall promptly issue a Procedural  
6 Order scheduling a procedural conference to discuss the scope of the proceeding.

7 IT IS FURTHER ORDERED that APS and TEP shall submit modifications as recommended  
8 by Staff to their Codes of Conduct as adopted in Decision No. 62416 (April 3, 2000) and Decision  
9 No. 62767 (August 2, 2000). Such proposed revisions shall be filed with the Commission and  
10 provided to any requesting party, within 60 days of the effective date of this Decision.

11 IT IS FURTHER ORDERED that an Electric Competition Advisory Group is hereby formed  
12 in order to facilitate communication and information sharing among Staff, stakeholders, and market  
13 participants.

14 IT IS FURTHER ORDERED that Staff shall prepare and file reports detailing the activities of  
15 the Advisory Group, as directed herein.

16 IT IS FURTHER ORDERED that APS and TEP shall comply with all of the findings and  
17 orders discussed herein.

18 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

19 **BY ORDER OF THE ARIZONA CORPORATION COMMISSION.**

20 *William A. McNeil*  
21 *James H. ...*  
22 *...*  
23 CHAIRMAN COMMISSIONER COMMISSIONER

24 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive  
25 Secretary of the Arizona Corporation Commission, have  
26 hereunto set my hand and caused the official seal of the  
27 Commission to be affixed at the Capitol, in the City of Phoenix,  
28 this 10<sup>th</sup> day of SEPT., 2002.

*Brian C. McNeil*  
BRIAN C. McNEIL  
EXECUTIVE SECRETARY

DISSENT \_\_\_\_\_  
LAF

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GENERIC PROCEEDINGS, ARIZONA PUBLIC  
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