OPEN MEETING 4 a

MEMORANDUM

TO: THE COMMISSION

FROM: Utilities Division

DATE: July 13, 2001

RE: STAFF REPORT FOR THE APPLICATION OF THE ARIZONA ELECTRIC POWER COOPERATIVE, INC. FOR VARIOUS AUTHORIZATIONS ASSOCIATED WITH ITS RESTRUCTURING (E-01773A-00-0826)

Attached is the Staff Report for the application of Arizona Electric Power Cooperative, Inc. for various authorizations associated with its restructuring. Staff recommends approval under several conditions.

Deborah R. Scott
Director
Utilities Division

DRS:LAJ:lhm\JMA

Originator: Linda A. Jaress

Attachment: Original and Eleven Copies

STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

ARIZONA ELECTRIC POWER COOPERATIVE, INC.
DOCKET NO. E-01773A-00-0826

APPLICATION
FOR VARIOUS AUTHORIZATIONS ASSOCIATED
WITH ITS RESTRUCTURING

JULY 2001

STAFF ACKNOWLEDGMENT

The Staff Report for Arizona Electric Power Cooperative, Inc. Docket No. E-01773A-00-0826, was prepared by Linda A. Jaress.

Linda A. Jaress

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EXHIBITS

On October 11, 2000, Arizona Electric Power Cooperative, Inc. ("AEPCO" or "the Cooperative") filed an application for approval and confirmation of various transactions enabling the Cooperative's restructuring into three affiliated entities. The approvals and confirmations requested include:

1. Approval of the transfer of AEPCO's transmission assets to Southwest Transmission Cooperative Inc. ("Southwest") and approval of the transfer of its cooperative service provider business to Sierra Southwest Cooperative Services, Inc. ("Sierra").

2. Approval of AEPCO and Southwest to execute notes, mortgages and assumption and indemnity agreements associated with the restructuring.

3. Approval of a partial requirements relationship between AEPCO and Mohave.

4. Approval of the revised Class A member unbundled tariff and the forgiveness of the Purchased Power and Fuel adjustment Clause.

5. Confirmation that AEPCO has complied with the requirements of Arizona Administrative Code ("A.A.C.") R14-2-1615 by this restructuring.

6. Approval of waivers or, alternatively, approval of AEPCO's Code of Conduct as described in Exhibit D.

7. Confirmation that the financial commitment conditions of Decision No. 61932 pertaining to Sierra have been satisfied.

8. Authorization of AEPCO, Southwest Transmission and Sierra to engage in any transactions and to execute any documents necessary to effectuate these authorization and complete the restructuring.

The initial application requested approval of revised rates that resulted in a rate decrease to AEPCO's members of 3.05 percent. On April 11, 2001, AEPCO amended the application eliminating the rate reduction proposed in the original application and proposing revised unbundled rates calculated to have no effect on AEPCO's revenues.

Description of AEPCO

AEPCO is a non-profit Arizona rural electric generation and transmission cooperative primarily engaged in the generation, transmission, purchase, and sale of electricity at wholesale. AEPCO supplies all of the electric power requirements of its six Class A member-owned, not-profit distribution cooperatives ("Class A Members") under full requirements capacity and energy contracts. These members are; Anza Electric Cooperative, Inc. (located entirely in California), Duncan Valley Electric Cooperative, Inc. (partially located in New Mexico), Graham County Electric Cooperative, Inc., Sulphur Springs Valley Electric Cooperative, Inc., Trico Electric Cooperative, Inc., and Mohave Electric Cooperative, Inc. ("Mohave"). These cooperatives serve a combined customer base of 114,720. Two of the Class A members provide natural gas utility service.

AEPCO also provides wholesale energy and transmission under power supply agreements with the City of Mesa, Salt River Project Agricultural Improvement and Power District ("SRP"), Electrical District No 2 and Morenci Water and Electricity ("MWE").

The Cooperative's generation facilities consist of six units at the Apache Generating Station located in Cochise County, Arizona, having a combined generating capacity of 520 MW. The largest generating units burn either coal or natural gas while the smaller units are natural gas-fired only. AEPCO's transmission facilities consist of over 580 miles of transmission line and twenty substations. The transmission line and substations are located entirely within the state of Arizona.

The Restructuring

AEPCO proposes to restructure into Southwest, Sierra and a new, restructured AEPCO. Sierra, which already holds a CC&N as an Arizona Electric Service Provider, will market power, provide staffing and other resources to Southwest and AEPCO and will sell other electricity-related services. Southwest will own and operate all of AEPCO's transmission assets. AEPCO will be a generation cooperative that also acts as a power broker for short-term power. Attached as Exhibit 1 is a chart portraying the division of AEPCO and the three entities' functions.

The necessary agreements and contracts to implement the restructuring have taken over five years to prepare and coordinate. From February 1999 through September 30, 2000, AEPCO spent approximately $2.4 million in outside counsel and consulting, internal meetings, travel and other costs related to the restructuring. AEPCO states that it anticipates additional costs of $500,000 to reach closing, assuming "moderate regulatory involvement".

Although the three entities will have separate functions and each will have its own Board of Directors, the Boards will primarily be chosen from the same pool of individuals from which AEPCO's current directors originate. AEPCO's Board is currently comprised of 14 Board members; two from each Class A member and one each from SRP and the City of Mesa. All three entities will share a common Chief Executive Officer, Chief Financial Officer, Chief Legal Officer and Internal Auditor.

According to the AEPCO Study Committee report on the restructuring, among the reasons for the restructuring are to increase competitiveness of AEPCO and its members, create efficiencies, make available more flexible power purchase arrangements to AEPCO's members and to diminish regulatory burdens.

As part of the restructuring, Mohave, AEPCO's largest Class A member, will convert from a full requirement member to a partial-requirement member. The new contract will be discussed below. The restructuring will also provide the five remaining Class A, full requirement members the opportunity to seek to become partial requirement customers in the future pursuant to separate conversion agreements subject to approval of the RUS.

Southwest Transmission Cooperative, Inc.

Southwest will acquire AEPCO's transmission assets and be responsible for their operation and maintenance and will sell transmission service to AEPCO's Class A full-requirements members and others. In addition, Southwest will receive all of AEPCO's regulatory assets that are currently being recovered by AEPCO through a Regulatory Asset Charge ("RAC").

Decision No. 62758, dated July 27, 2000, approved the RAC and the transfer of the RAC to Southwest. At June 30, 2000, the balance of the unrecovered Regulatory Assets equaled $20.6 million. For the first eight months of the RAC's existence, AEPCO collected $1.6 million. The RAC, which is currently set by Commission order at $0.00150, will be charged to all customers of Southwest. The amount collected under the RAC, as currently charged by AEPCO, is also credited to the customer because the RAC was intended to be recovered through current rates, not in addition to current rates. However, Southwest will charge the RAC as an addition to its rates.

According to the Restructuring Agreement, Section 4(d)(I), the purchase price for AEPCO's transmission business and assets will be the fair market value of the non-generation assets determined in the "Final Appraisal". The first appraisal was performed over the period of May to September 1998 and was updated in September 2000 and again in June 2001. The results of the appraisal were consistently that the market value of the transmission assets equals book value (original cost, less depreciation).

Using the amounts shown on Schedule 3 to the Restructuring Agreement supplied with the Application, Southwest will purchase approximately $99.0 million of transmission assets from AEPCO. The purchase will be financed by the assumption of $98.0 million of AEPCO's Rural Utility Services ("RUS") debt and RUS guaranteed debt and by an infusion of $1.0 million of membership capital (equity) into Southwest by AEPCO. RUS approval is necessary for Southwest's assumption of the RUS debt. These amounts are subject to adjustment at closing based on the final appraisal and AEPCO's financial statements at that time.

AEPCO's Class A members, along with AEPCO and Sierra, will all become members of Southwest. Southwest will be a non-taxable cooperative, subject to the annual member income qualifications under IRS Code Section 501c(12).

The application requests approval to transfer the transmission portion of AEPCO's CC&N to Southwest. After closing, Southwest will immediately generate revenues from AEPCO's Class A members and others. The employees who will operate Southwest's transmission system are currently the AEPCO employees who operate the same transmission system. For these reasons, Staff believes that Southwest is a fit and proper entity to receive the transmission portion of AEPCO's assets and CC&N and recommends that the Commission approves the transfer.

Arizona Electric Power Cooperative, Inc.

AEPCO will retain the generating assets and will continue to provide electric capacity and energy to its Class A members, and others, using its generating units along with purchased power. Power trading, power billing and scheduling will be performed by AEPCO.

AEPCO will obtain transmission services from Southwest under Southwest's Open Access Transmission Tariff ("OATT") in order to continue to make bundled sales to SRP, Mesa, ED2 and MW&E and other third-party sales. When AEPCO makes a bundled sale to the Class A, all-requirements members and to SRP, etc., AEPCO will acquire transmission from Southwest or others, as needed. When AEPCO makes an unbundled sale to other parties, the customer will be responsible for obtaining transmission whether from Southwest or other transmission providers.

AEPCO will remain a non-taxable cooperative, subject to the annual member income qualifications under IRS Code Section 501c(12). The income qualification is that at least 85 percent of its gross income will be "related income" from its members.

Sierra Southwest Cooperative Services, Inc.

The application also requests approval to transfer various non-generation and non-transmission AEPCO assets (primarily financial assets) from AEPCO to Sierra. Sierra will provide support services for AEPCO and Southwest. This support includes management of improvements and additions to facilities, employee development, contracting and subcontracting, warehousing, inventory control, fuel procurement, environmental permitting, Engineering services, financial and accounting services, budgeting, forecasting planning and scheduling, media and public relations and legal services. Sierra will also engage in competitive retail electric sales activities and will function as a power marketer for wholesale power sales and load aggregation. AEPCO's Class A members, AEPCO and Southwest Transmission will be members of Sierra.

Sierra will be a taxable cooperative because, initially, the bulk of its income will come from its staffing services rather than the sale of electricity.

Sierra will enter into joint marketing agreements with the Class A members whereby Sierra will market and sell electricity to members of the Class A members who desire to purchase electricity on the competitive market. Sierra also intends to offer energy-related products such as distributed generation equipment, energy management, power quality solutions, facility operations and maintenance service, consolidated billing and other services.

Pursuant to the Commission's Electric Competition Rules, Sierra may only offer competitive service in the service areas of utilities whose service areas have been opened to competition. Thus, Sierra cannot offer competitive service in the Class A member distribution cooperatives' service areas until the Commission has deemed those areas open to competition.

AEPCO and Southwest will make cash capital contributions to Sierra in the amount of $4.0 million to enable its formation. Because substantially all of AEPCO's assets are subject to RUS and the National Rural Utilities Cooperative Finance Corporation ("CFC") mortgages, AEPCO is seeking a release of the Sierra business and assets from the mortgages.

The market power study submitted to FERC by Southwest and Sierra reports that Sierra will provide personnel to fill non-core positions at AEPCO and Transco. Staffing agreements will govern the functions of and payments for these employees. AEPCO and Southwest will provide management directives, policies, and supervision of Sierra's employees. The Sierra employees assigned to Transco will be subject to the OASIS Standards of Conduct. Thus, structurally, Sierra employees will not have operational control over the activities of AEPCO or Southwest.

Pursuant to staffing agreements, Sierra will provide staffing and other services to AEPCO and Southwest at cost plus performance incentives. Performance Plans will be established jointly by the Boards of Directors of Sierra and Southwest and the Boards of Directors of Sierra and AEPCO. Each year, or at other agreed upon times, the Performance Plans may be modified. The Performance Plans will include performance goals of Sierra together with incentives for the performance of Sierra's obligations. Because the incentive plans do not currently exist, Staff is unable to review them to determine which levels of the organization are included in the plan, who the likely beneficiaries of the plan are and who will pay for the plan.

On August 27, 1999, the Commission issued Decision No. 61932 granting Sierra a Certificate of Convenience and Necessity ("CC&N") to operate as an electric service provider and authorizing Sierra to supply competitive retail electric services as a load-serving entity and as an aggregator in all areas of the State of Arizona which are opened to retail electric competition. The Decision also authorized Sierra to resell meter service and meter reading service.

An Ordering paragraph in Decision No. 61932 requires Sierra to file documents "to be approved by the Utilities Division Director that clarify the extent of the financial commitment Sierra...has received from Arizona Electric Power Cooperative, and the availability and amount of the anticipated operating line of credit." Per the application and the Restructuring Agreement among AEPCO, Southwest and Sierra, Sierra will be financed through capital contributions of $4.0 million from Southwest and AEPCO. Sierra has also applied for credit support in the amount of $500,000 from the National Rural Utilities Cooperative Finance Corporation ("CFC"). The funds from AEPCO, Southwest and the CFC will be used primarily to cover a thirty to forty-five day lag between the generation of revenue and the payment of payroll. Staff believes that the provision of this information fulfills compliance with Commission Decision No. 61932.

The Transfer of Debt to Southwest and the Issuance of Replacement Debt by AEPCO

The application also requests approval for AEPCO and Southwest to execute notes, mortgages and assumption and indemnity agreements associated with the restructuring. These will be necessary for the transfer of some of AEPCO's debt to Southwest. Any debt assumed by or transferred to Southwest from AEPCO will be issued at identical interest rates and maturities as the debt presently carries. Because the amount of debt to be assumed or replaced by Southwest will not be known precisely until the close of the transaction, the Cooperatives have requested that approval for Southwest to execute notes, mortgages and assumption and indemnity agreements be for a total amount of up to $100.0 million. Also, AEPCO requests approval to issue replacement notes for the debt they are retaining.

None of the debt for which approval is requested is "new" debt. The total will sum to AEPCO's debt immediately before closing. Staff believes that these debt transactions are necessary to effectuate the restructuring. Because Southwest's transmission rates and AEPCO's rates for generation are set to meet their annual revenue requirement, and debt service related to the assumed debt is part of that revenue requirement, Southwest and AEPCO should have the ability to make principal and interest payments on the assumed debt. If the restructuring is approved, Staff recommends approval for AEPCO and Southwest to execute notes, mortgages and assumption and indemnity agreements in an amount not to exceed AEPCO's debt immediately before closing.

Rural Utility Services

AEPCO currently has a balance of approximately $200.0 million in RUS and RUS guaranteed debt. The RUS mortgage includes RUS oversight over much of

AEPCO's assets and business. To protect its interests in being repaid in a timely manner, the RUS imposed restrictions on the restructuring. One restriction is the retention by AEPCO of the existing bundled sales contracts between AEPCO and the Class A all-requirements members. The RUS also limited Sierra's control over the activities of AEPCO and Southwest because RUS will have no control over Sierra. The reason for this restriction is to ensure that AEPCO and Southwest's margins are not appropriated by Sierra compromising their ability to make timely debt payments to RUS.

Final RUS approval of the notes and replacement debt will occur after AEPCO and Southwest have received Commission approval.

Federal Energy Regulatory Commission

On April 11, 2001, Sierra and Southwest filed an application with the Federal Energy Regulatory Commission ("FERC") relating to the restructuring of AEPCO. Sierra requested FERC authorization of a rate schedule for the wholesale sale of electric energy and capacity at market-based rates and for authorization for the Resource Integration Agreement which governs some of Sierra's wholesale power sales. Sierra also requested that FERC issue a declaratory order disclaiming jurisdiction over AEPCO and Southwest because they have RUS and RUS guaranteed debt. Southwest requested that FERC make a finding that Southwest's Open Access Transmission Tariff is an acceptable reciprocity tariff and that its proposed Standards of Conduct satisfy the standards of Order No. 889.

On May 30, 2001, without a hearing or suspension, FERC issued an order on these matters. Sierra and Southwest received all approvals and authorizations requested.

Jurisdiction

The proposed restructuring raises several issues concerning the Commission's and FERC's jurisdiction over AEPCO, Sierra and Southwest if the restructuring is approved. Staff, through the Commission's Legal Division and FERC counsel, has addressed these issues with AEPCO's local and FERC counsel. The Legal Division and AEPCO agree that the restructuring will not alter the jurisdiction of either this Commission or FERC over AEPCO and Southwest. AEPCO has provided bundled generation and transmission services to its member cooperatives under tariffs approved by the Commission for the past 40 years. The restructuring does not alter the existing jurisdiction the Commission has over generation or transmission rates.

Through its counsel, AEPCO has noted and Staff counsel agrees, that jurisdiction over transmission has been mixed and competing between the Commission and FERC. AEPCO' s restructuring application requests that the Commission approve a tariff for AEPCO that will pass through Southwest's FERC approved OATT charges to its member cooperatives. The Legal Division and AEPCO agree that the Commission has jurisdiction over the tariff.

Rates

AEPCO is also requesting approval of rates to its Class A members. AEPCO's current rates to its Class A members were set by Decision No. 58405 dated September 3, 1993. The rates set were bundled rates of $15.25 per kW of billing demand plus $0.0228 per kWh. AEPCO's original restructuring application requested approval of a tariff that represented a rate reduction to its Class A members. AEPCO's amended application requests approval of a tariff that was designed to result in no change in the Class A members' total power bills and that the rates for generation charged to its all requirements Class A members be set at $12.44 per kW of billing demand plus $0.01989 per kWh.

Southwest's rates for transmission for Class A members and for all other parties are set forth in its OATT which has already received FERC approval. The OATT rates include a monthly demand charge determined by multiplying the proportion of the customer's load to Southwest's load by one-twelfth of Southwest's annual revenue requirement. According to the OATT, Southwest's revenue requirement for network integration transmission service is $13.4 million, "effective until amended by Southwest." This translates into initial transmission rates of $3.244 per kW per month.

Although the total of the generation and transmission demand rates of $12.44 and $3.244, respectively, equals $15.684 per kW and exceeds the bundled demand rate of $15.25 per kW, the new kWh charge of $0.01989 is less than the bundled kWh charge of $0.0228. When the unbundled rates are applied to the Class A members' bills for the twelve months ending December 31, 2000, the resulting pro forma power bills were $1.0 million less than the actual total power bills during 2000. On an individual basis, the pro forma power bills of the Class A members all were less than their actual bills with Mohave experiencing the greatest reduction of 2.14 percent and Anza experiencing the smallest reduction of 0.21 percent. Thus, all factors held constant, the impact on all of the Class A members should be power bills slightly lower than they would have been under the old, bundled rates.

Financial Health

The attached Exhibit 2 shows highlights of AEPCO's financial statements for the past six years. It can be seen that AEPCO's financial health has steadily improved since 1995. Except for the $6.7 million write-off of the PPFAC bank balance and $4.1 million shortfall charge-back expense related to sales to California, AEPCO's net margins (equivalent to net profit for an investor-owned utility) in 2000 would have been the highest in six years. The Exhibit shows that Long-term Debt has steadily declined while Membership Capital (equivalent to "common equity" for investor-owned utilities) steadily increased and turned positive in 2000 for the first time in many years. Interest Expense has also steadily declined over the six years.

Another indication of AEPCO's improving financial health is the balance of Cash and Cash Equivalents. This balance of this account, which represents cash and investments that are readily converted to cash, was $49.0 million at December 31, 2000, and is the highest of the six years shown. Unfortunately, AEPCO will be unable to distribute this cash to its member cooperatives for several years. The RUS sets limits on distributions by borrowers to members and requires the borrower's equity to be greater than or equal to 30 percent after any distribution. Because AEPCO's current capital structure is comprised of approximately 97.0 percent debt and 3.0 percent equity, it may take several years for AEPCO to reach 30 percent equity.

It is notable that of the total megawatt hours sold by AEPCO in 2000, nearly 50 percent were sold to other than Class A members, a proportion that has increased each year shown on the Exhibit.

Decision Nos. 58405 and 58792

During 1992, AEPCO filed its most recent application for a rate increase with the Commission. After the filing, but before the hearing, Staff learned of allegations made by then current and former AEPCO employees concerning actions by AEPCO management, Board members, employees and agents.

When the Commission issued the rate case Decision, Decision No. 58405, dated September 3, 1993, it ordered the record to remain open to allow for consideration of the results of Staff's investigative audit addressing the allegations prior to the issuance of a final order. The Decision also required AEPCO to defer legal expenses associated with fuel issues and ordered that the treatment of those expenses be examined in a future rate proceeding. Finally, the Decision also noted that "The lack of information concerning the cost of providing service prevents us from adopting a rate design other than the one currently in place." The Commission ordered AEPCO to conduct a fully allocated embedded cost of service study "in conjunction with its next rate filing."

In February 1994, Staff filed a report that contained Points of Resolution between Staff and AEPCO that resolved the allegations. The Commission adopted the Points of Resolution in Decision No. 58792, dated September 21, 1994. The Points of Resolution addressed such issues as travel policy, delegation of authority to the General Manager, corporate records, retention of records and the Employee Code of Conduct. One of the important issues addressed in the Points of Resolution and the Decision was AEPCO's use of the PPFAC to recover excessive fees, judgements and awards paid to an attorney. The Decision required that "only authorized fuel, purchased power and DSM related costs shall be recovered through the PPFAC as provided in Decision No. 58405."

During the years 1994 through 1996, Staff and AEPCO corresponded through a series of letters regarding the PPFA. The subject of the letters was AEPCO's unilateral change in the factors included in the computation of its PPFA bank balance. Staff was concerned that AEPCO's new method resulted in an undercollected balance while the old method resulted in an overcollected balance. The controversy was left unresolved.

Purchased Power and Fuel Adjustor Clause

The Cooperative's application includes a request for Commission approval to "(1) forgive the under-collected balance in its PPFAC bank as of the effective date of the restructuring and (2) to eliminate its PPFAC on an on-going basis."

Purchased power and fuel adjustor clauses for Arizona utilities may be created and set during a rate case wherein a base cost of fuel and purchased power is determined and included in base rates. The base cost of fuel and purchased power adopted in AEPCO's last rate case and used in the subsequent fuel adjustor filings is $0.01714 per kWh. AEPCO's most recent filing of its fuel and purchased power cost adjustment indicates that its current cost of fuel and purchased power is $0.026034. The adjustor itself has been set at zero since AEPCO's last rate case in 1993.

At December 31, 2000, AEPCO's PPFAC bank balance was undercollected by approximately $6.7 million. According to the notes to AEPCO's audited annual report, "The Cooperative has elected to charge-off the PPFAC balance, totaling approximately $6.7 million as of December 31, 2000 and not seek future recovery of the regulatory asset in the form of an under-collected PPFAC balance." The required monthly PPFA filings submitted to the Commission also indicate that the $6.7 million balance has been "forgiven". AEPCO, then, has already completed the process for which it has requested approval. As shown on the PPFAC filings since the forgiveness of the $6.7 million of the undercollection, between January 1 and March 31, 2001, AEPCO has accumulated an additional undercollected balance of $2.3 million.

The fundamental rationale for a fuel adjustment clause is that fuel price can change radically based on the overall energy market. During much of the time that AEPCO's restructuring was being planned, fuel prices were dropping. During the more recent past, there has been a dramatic reversal of that trend. It is likely that for at least the near future, energy prices will be unstable. As of March 2001, AEPCO's own annualized fuel costs have increased by $16.0 million over those experienced in 1999. Thus, the first problem with elimination of the adjustor is that AEPCO must assume the risk of more significant increases in fuel and purchased power prices.

Another factor that causes concern is that the cumulative expenses included in AEPCO's reported undercollected PPFAC balance have not been audited by Staff in several years. Staff cannot confirm the amount undercollected, if any, without a complete audit of the historical PPFAC filings, accounting and related invoices which would further delay the processing of this application. Also supporting the need for an audit of the PPFAC filings is the previously mentioned series of letters between AEPCO and Staff dated between February 1994 and August 1996. These letters addressed a controversy regarding AEPCO's method of calculating its PPFAC and focused on whether AEPCO's Class A members were receiving their fair allocation of the least cost generation. The controversy was never resolved.

As fuel and purchased power costs have been escalating recently, Staff believes that the Commission should approve nunc pro tunc the write-off of the December 31, 2000, PPFAC undercollected balance of $6.7 million. However, Staff recommends that the Commission order the opening of a new docket in which to examine the PPFAC. Within the docket, Staff would perform an audit of the PPFAC filings and balance to verify the balance and verify AEPCO's compliance with previous Commission orders. Staff would make recommendations to the Commission as to the appropriate amount of the write-off and as to the continuation or elimination of the adjustor.

Partial Requirements Contract

AEPCO as part of its restructuring application requests the approval of a Partial Requirements Capacity and Energy Agreement with Mohave. As a result of the agreement Mohave would no longer be an all requirements member and would have a different rate structure than the other Class A members. Mohave will pay for electric service based on a three-part charge. Mohave's rate as a partial requirement member will consist of a fixed charge and charges based on an O&M rate and an energy rate. The fixed charge represents Mohave's share of AEPCO's debt payments and is instrumental in receiving RUS approval. In contrast, the other Class A members will continue to pay for service through traditional demand and energy rates. Mohave will be required to pay for the fixed charge component of the rate irrespective of its usage. The all requirements members will be billed based on their usage.

AEPCO will supply Mohave power and energy based on its historic demand and investment. However, Mohave will be free to procure its additional needs from other sources.

Due to the recent volatility in electricity prices, there is some concern that Mohave will be exposed to considerably more pricing risk under the proposed partial requirements arrangement. This risk would be immediately shared with its members because these fluctuating costs would be recovered from the members under Mohave's purchased power and fuel adjustor which is changed monthly. However, because Mohave will only participate in the wholesale market for its incremental needs, the risk exposure should be minimal. In return, the partial requirement arrangement provides Mohave the opportunity to pursue advantageous pricing arrangements as the wholesale market matures and becomes less volatile and chaotic. Therefore, the Partial Requirements Capacity and Energy Agreement should be approved.

Code of Conduct

In the restructuring application, AEPCO proposes a Code of Conduct between itself and Sierra. Also, the application requests approval of a proposed Code of Conduct between the Class A members and Sierra. These Codes of Conduct were submitted to comply with A.A.C. R14-2-1616. However, AEPCO contends that the Code of Conduct rules do not apply and therefore request waivers from these rules or approval of the Codes of Conduct as proposed.

In the restructured company, Sierra will perform several roles. For instance, according to Sections 5.3 and 5.4 of the Resource Integration Agreement Sierra will provide AEPCO with bulk power supply planning resources including analysis, recommendation and negotiation with respect to resource acquisition. According to Section 8.3, Sierra will also make reasonable efforts to arrange capacity and/or energy sales of a duration of one year or more. Further, per Section 9, Sierra may purchase capacity and energy from the surplus resources for retail sales as permitted by the Joint Marketing Agreements with the member cooperatives. Further, according to the Joint Marketing Agreement, Sierra will be an electric service provider in conjunction with the member cooperatives and will provide competitive retail electric services.

This overlap of roles in both the wholesale and retail markets creates potential problems. For instance, if Sierra were able to procure power at an excellent price, where would that power go? Would Sierra sell it in the wholesale market and keep the margins, or would they provide the power to Class A members?

AEPCO and Sierra acknowledge such problems to some extent. AEPCO will comply with the FERC's rules, procedures and guidelines concerning the separation of the merchant and power marketing functions of an electric utility from its transmission functions. Appropriate standards of conduct will be followed to ensure adequate separation. However, Sierra's role as a wholesale and retail marketer are not addressed in the proposed Codes of Conduct. AEPCO suggests that the member owned corporate structure of the cooperatives minimizes these concerns because any margins in either market will accrue to the members.

Further, Sierra as an electric service provider will work in conjunction with the member distribution cooperatives, which are rate regulated utilities, through the Joint Marketing Agreement. For the other utilities in the state, a separation of the competitive provider and the utility is required. AEPCO contends that if it cannot offer the competitive services through this arrangement, the services will likely not be provided at all in the rural regions of the state.

The fact that AEPCO, its affiliates and the member distribution cooperatives are member owned and the fact that they serve a region of the state that would likely not be profitable enough for others to service should not be ignored. However, it would be inappropriate to grant AEPCO's request for waivers at this time. Another alternative should be considered. The Commission should approve the Code of Conduct at this initial stage and reserve the right to impose additional restrictions if problems arise or if the demand for competitive services becomes larger than anticipated and would support other service providers in the rural regions of the state. These issues should be re-examined in AEPCO's and Southwest's next rate case filing.

Status of AEPCO Litigation

Although AEPCO's plan to restructure predates the Commission's Electric Competition Rules, AEPCO and some of its member cooperatives have challenged the Commission's electric competition rules in court. Last summer, a Superior Court judge vacated the Commission's rules. The Commission has appealed that judgment to the Court of Appeals, where the case is currently in the briefing stage. The Commission's orders, including its rules, remain in effect pending appeal; accordingly, the electric competition rules are currently still valid despite the Superior Court's judgment. Nonetheless, it is far from certain what the outcome of the matter will be on appeal. The spectrum of outcomes ranges from the Commission's rules being entirely upheld, partially upheld or entirely set aside.

Impact on Class A Members

According to AEPCO's response to data request LAJ-2-16, there will be no change in risk to AEPCO's all requirement members. As previously mentioned, there could be some immediate exposure to wholesale electricity price changes for the members of Mohave as Mohave's PPFA is changeable monthly. The remaining Class A members will have the ability to seek to become partial requirements customers of AEPCO pursuant to a Conversion Agreement, approval of the RUS and entry into agreements with Southwest for transmission services. If members require transmission greater than what is provided for under their contract with AEPCO, those services will be available from Southwest under its OATT.

Issues

Since inception, AEPCO has provided centralized services to fulfill its function as provider of power to its member distribution customers. Although AEPCO expects some cost savings through Sierra's provision of centralized services, some costs are likely to increase under the proposed restructured organization. The cost of the reorganization itself and the costs of educating, transporting and housing three Boards of Directors are costs that will increase. Sierra's costs which would be passed on to AEPCO and Southwest will include income taxes which the cooperatives currently do not pay. Lines of communications that currently enable AEPCO employees to share information will have to be monitored and in some cases eliminated pursuant to the Codes of Conduct. This may result in confusion and cause additional inefficiencies.

Because so many years have passed since the Commission has examined the revenue requirements of AEPCO, to insure that asset and liability allocations among the three entities have been performed in a fair and equitable manner, to insure that the ultimate customers of AEPCO benefit from any cost savings from the restructuring, AEPCO's members, and to insure that AEPCO's and Southwest's rates are fair and reasonable, Staff recommends that the Commission order AEPCO and Southwest to each file a rate case eighteen months after the closing of the restructuring. The rate filing would encompass one year of operations under the new structures and provide the cooperatives an appropriate amount of time to close the books and to prepare a rate case submission.

In the course of the rate case, Staff would perform a complete audit of the books and records to determine the following; a) if there has been full compliance with previous Commission Decisions, b) if the allocations among the three entities were reasonable, c) if the restructured cooperatives are experiencing savings from the restructuring that exceed the costs and e) the success, fairness and costs of the performance/incentive plans proposed to be implemented by Sierra, AEPCO and Southwest.

Staff is concerned that Mohave's timing in its decision to become a partial-requirements member of AEPCO and exposing itself to the vicissitudes of the marketplace for electricity is poor. Mohave's timing to convert its all-requirements contract to a partial-requirements contract could result in Mohave's becoming more vulnerable to cost of purchased power increases.

AEPCO and its Class A members are owned by their respective members who voted for their respective Boards of Directors. The members of the Boards of Directors have been instrumental in the planning and implementation of the steps toward restructuring and are educated and informed about the related risks and rewards. It can be argued that this was a democratic process and the Commission should approve what the members' representatives have requested.

On the other hand, AEPCO's initial application included a rate decrease of over 3.0 percent. This benefit was eliminated in the amended application. Therefore, the one, unequivocal benefit, which could immediately be passed on to the ultimate end users, disappeared. To more clearly meet the public interest standard, more clear and convincing benefits of the restructuring, the transfer of assets, the transfer of the transmission CC&N and the related financing approvals should be apparent.

Thus, Staff has attempted to reconcile the two opposing points of view into recommendations for approval by recommending the Commission adopt certain protections of the ultimate ratepayers.

Recommendations

Staff recommends approval of the application and the transactions to effectuate the restructuring. However, because of the many issues raised by this application, the volatility of the energy market and the uncertainty of the outcome of the litigation involving the Commission's Electric Competition Rules, there are several conditions that should be attached to the Decision in this matter.

Staff recommends approval of the forgiveness of the December 31, 2000, undercollected PPFAC balance. However, Staff also recommends that the Commission authorize Staff to request a docket be opened and a procedural order be issued within 90 days from the decision in this docket. The purpose of the docket would be to examine AEPCO's PPFAC. Staff would perform an audit of AEPCO's PPFAC filings and balance to verify the balance and verify AEPCO's compliance with previous Commission orders. At that time, Staff will also make a recommendation regarding the continuation or discontinuation of the PPFAC and a recommendation regarding the balance forgiven.

Staff recommends that the Commission order that the new AEPCO and Southwest file rate cases eighteen months from the closing of the restructuring. In the rate applications, AEPCO and Southwest should include an analysis of the savings and benefits enjoyed from the formation of Sierra that would not have been experienced without the restructuring and include a cost of service study as ordered by Decision No. 58405.

Staff recommends that the Commission reserve the right to impose additional restrictions on Sierra at the time of AEPCO and Southwest's next rate case if problems arise regarding Sierra's role as a wholesale purchaser and a cooperative service provider or if the demand for competitive services becomes larger than anticipated and would support other service providers in the rural regions of the state.

Staff recommends that the Commission require Southwest to obtain any necessary franchises and file them in this docket when obtained.

Staff recommends approval of the transfer of AEPCO's transmission assets to Southwest and certain assets to Sierra.

Staff recommends that the Commission find that to the extent A.A.C. R14-2-1615 applies to a generation and distribution cooperative, this restructuring complies with that rule.

Staff recommends approval of the transfer of the transmission portion of AEPCO's CC&N to Southwest.

Staff recommends approval of the execution by AEPCO and Southwest of notes, mortgages and assumption and indemnity agreements associated with the restructuring, the total not exceeding AEPCO's outstanding debt immediately previous to the time of closing.

Staff further recommends approval of the partial requirements relationship between AEPCO and Mohave with the final executed agreement to be filed with the Commission upon completion of the restructuring. Such relationship should not differ materially from that described in the Application and its exhibits and schedules.

Staff recommends approval of the revised Class A member all requirements tariff attached as Exhibit C to the Amended Application.

Exhibit 1

SIMPLIFIED
RESTRUCTURING OF AEPCO
(Functional Organization)

Sierra Southwest Cooperative Services
(Coop Service Provider)

Wholesale Purchases
Wholesale Marketing
Resource Aggregators
System Load & Transmission Integrator
Administrative Support Services
Financial Services
Accounting
Purchasing Services
Facility Management
Safety & Environment
Capacity & Resource Plan
Load Forecasting
Engineering

Staffing for AEPCO and Southwest
Pre-Scheduling
Real Time Sales & Purchases
Resource Aggregators
Off-system Load Integrator
Retail Energy Sales and Services
Energy Audits
Product Development
Promotional Advertising
Industry Service Requests
Energy Service to National
and Regional Accounts

AEPCO
(Generation Provider)

Operator of Apache Station
Generation
Current Power Purchase and
Sales Contracts
Carbon Coal Company

Southwest Transmission Cooperative
(Transmission Provider)

X-Mission
Breakers, Outages
Emergencies
Control Area Control
Ops & Maintenance
Construction
SCADA & Telecom.

Exhibit 2

Selected Financial Information

Arizona Electric Power Cooperative, Inc.

	2000	1999	1998	1997	1996	1995
Revenue	$ 238,086,432	$ 163,363,610	$ 171,129,553	$ 175,649,337	$ 169,141,472	$ 155,036,768
Power Generation Expense	$ 105,065,344	$ 63,531,500	$ 60,366,076	$ 55,000,106	$ 49,843,405	$ 57,402,792
Purchased Power Expense	$ 53,831,265	$ 37,640,069	$ 39,354,506	$ 48,723,030	$ 46,146,925	$ 29,608,514
Transmission Expense	$ 9,741,932	$ 9,381,892	$ 8,498,806	$ 7,574,992	$ 6,558,831	$ 5,901,702
Interest Expense	$ 19,328,210	$ 19,569,060	$ 19,982,256	$ 22,252,860	$ 24,114,724	$ 24,364,453
Net Margin	$ 12,041,707	$ 4,799,954	$ 12,289,836	$ 14,589,308	$ 8,405,447	$ (3,356,907)
Cash and Cash Equiv.	$ 48,976,501	$ 15,490,868	$ 36,713,104	$ 9,221,460	$ 22,040,058	$ 25,796,279
Long-term Debt	$ 286,772,084	$ 303,436,505	$ 316,368,227	$ 323,359,254	$ 340,838,241	$ 354,298,476
Membership Capital	$ 8,068,495	$ (3,973,212)	$ (8,773,166)	$ (21,063,102)	$ (35,652,410)	$ (44,057,857)
mWh Sold to Class A Members	2,126,156	2,048,194	2,959,466	3,474,846	3,246,446	2,885,954
% Sold to Class A members	51.6%	55.6%	76.1%	81.9%	84.6%	88.5%
mWh Sold to Others	1,992,654	1,632,378	931,776	770,068	588,774	374,872
% Sold to Others	48.4%	44.4%	23.9%	18.1%	15.4%	11.5%
mWh Sold--Total	4,118,810	3,680,572	3,891,242	4,244,914	3,835,220	3,260,826
# of Customers of Class A Members	114,720	105,956	102,538	101,315	96,315	92,742

Source: AEPCO Annual Reports

BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
Chairman
JIM IRVIN
Commissioner
MARC SPITZER
Commissioner

IN THE MATTER OF THE APPLICATION OF THE ARIZONA ELECTRIC POWER COOPERATIVE, INC., FOR VARIOUS AUTHORIZATIONS ASSOCIATED WITH ITS RESTRUCTURING	))))))	DOCKET NO. E-01773A-00-0826 DECISION NO. __________ ORDER

Open Meeting
July 24 and 25, 2001
Phoenix, Arizona

FINDINGS OF FACT

1. On October 11, 2000, Arizona Electric Power Cooperative, Inc. ("AEPCO" or "the Cooperative") filed an application for approval and confirmation of various transactions enabling the Cooperative's restructuring into three affiliated entities. The approvals and confirmations requested include:

A.) Approval of the transfer of AEPCO's transmission assets to Southwest Transmission Cooperative Inc. ("Southwest") and approval of the transfer of its cooperative service provider business to Sierra Southwest Cooperative Services, Inc. ("Sierra").

B.) Approval of AEPCO and Southwest to execute notes, mortgages and assumption and indemnity agreements associated with the restructuring.

C.) Approval of a partial requirements relationship between AEPCO and Mohave.

D.) Approval of the revised Class A member unbundled tariff and the forgiveness of the Purchased Power and Fuel Adjustment Clause.

E.) Confirmation that AEPCO has complied with the requirements of A.C.C. R14-2-1615 by this restructuring.

F.) Approval of waivers or, alternatively, approval of AEPCO's Code of Conduct.

G.) Confirmation that the financial commitment conditions of Decision No. 61932 pertaining to Sierra have been satisfied.

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H.) Authorization of AEPCO, Southwest Transmission and Sierra to engage in any transactions and to execute any documents necessary to effectuate these authorization and complete the restructuring.

2. The initial application requested approval of revised rates that resulted in a rate decrease to AEPCO's members of 3.05 percent.

3. On April 11, 2001, AEPCO amended the application and eliminated the rate reduction proposed in the original application and proposed revised unbundled rates calculated to have no effect on AEPCO's revenues.

Background

4. AEPCO is a non-profit Arizona rural electric generation and transmission cooperative primarily engaged in the generation, transmission, purchase, and sale of electricity at wholesale. AEPCO supplies all of the electric power requirements of its six Class member-owned, not-for-profit distribution cooperatives ("Class A Members") under full requirement capacity and energy contracts. These members are Anza Electric Cooperative, Inc. (located entirely in California), Duncan Valley Electric Cooperative, Inc. (partially located in New Mexico), Graham County Electric Cooperative, Inc., Sulphur Springs Valley Electric Cooperative, Inc., Trico Electric Cooperative, Inc., and Mohave Electric Cooperative, Inc. ("Mohave"). These cooperatives serve a combined customer base of 114,720.

The Restructuring

5. AEPCO proposed to restructure into Southwest, Sierra and a new, restructured AEPCO.

A) Sierra, which already holds a CC&N as an Arizona Electric Service Provider, will market power, provide staffing and other resources to Southwest and AEPCO and will sell other electricity-related services.

B) AEPCO will be a generation cooperative that also acts as a power broker for short-term power.

C) Southwest will own and operate all of AEPCO's transmission.

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6. AEPCO submitted a Study Committee Report on the Restructuring that outlined the purposes for restructuring which include: to increase competitiveness of AEPCO and its members; create efficiencies; make available more flexible power purchases arrangements to AEPCO's members; and to diminish regulatory burdens.

7. The necessary agreements and contracts to implement the restructuring have taken over five years to prepare and coordinate, and has cost approximately $2.4 million for outside counsel and consulting fees, internal meetings, travel and other costs related to the restructuring.

8. AEPCO has agreed that the restructuring will not alter the existing jurisdiction of either this Commission or the Federal Energy Regulatory Commission ("FERC") over AEPCO and Southwest or over their generation and transmission rates.

9. AEPCO' s application requested that the Commission approve a tariff for AEPCO that will pass through Southwest's FERC approved OATT charges to its member cooperatives. AEPCO agreed that this Commission has jurisdiction over the tariff.

10. Southwest will purchase approximately $99.0 million of transmission assets from AEPCO. The purchase will be financed by the assumption of $98.0 million of AEPCO's Rural Utilities Services ("RUS") debt and guaranteed debt and by an infusion of $1.0 million of membership capital into Southwest by AEPCO. RUS approval is necessary for Southwest's assumption of the RUS debt. These amounts are subject to adjustment at closing based on the final appraisal and AEPCO's financial statements at that time.

11. AEPCO's Class A members, along with AEPCO and Sierra, will all become members of Southwest. Southwest will be a non-taxable cooperative, subject to the annual member income qualifications under IRS Code Section 501c(12).

12. AEPCO will retain the generating assets and will continue to provide electric capacity and energy to its Class members, and others, using its generating units along with purchased power. Power trading, power billing and scheduling will be performed by AEPCO.

13. AEPCO will obtain transmission services from Southwest under Southwest's Open Access Transmission Tariff ("OATT") in order to continue to make bundled sales to SRP, Mesa, ED2 and MW&E and other third-party sales. When AEPCO makes a bundled sale, AEPCO will acquire

transmission from Southwest or others, as needed. When AEPCO makes an unbundled sale to other parties, the customer will be responsible for obtaining transmission whether from Southwest or other transmission providers.

14. AEPCO will remain a non-taxable cooperative, subject to the annual member income qualifications under IRS Code Section 501c(12). The income qualification is that at least 85 percent of its gross income will be "related income" from its members.

15. On August 27, 1999, the Commission issued Decision No. 61932, which granted Sierra a Certificate of Convenience and Necessity ("CC&N") to operate as an electric service provider and authorized Sierra to supply competitive retail electric services as a load-serving entity and as an aggregator in all areas of the State of Arizona which are opened to retail electric competition. The Decision also authorized Sierra to resell meter service and meter reading service.

16. This application also requests approval to transfer various non-generation and non-transmission AEPCO assets (primarily financial assets) from AEPCO to Sierra. Sierra will provide support services for AEPCO and Southwest. This support includes management of improvements and additions to facilities, employee development, contracting and subcontracting, warehousing, inventory control, fuel procurement, environmental permitting, engineering services, financial and accounting services, budgeting, forecasting planning and scheduling, media and public relations and legal services.

17. Sierra also intends to offer energy-related products such as distributed generation equipment, energy management, power quality solutions, facility operations and maintenance service, consolidated billing and other services.

18. Sierra will also engage in competitive retail electric sales activities and will function as a power marketer for wholesale power sales and load aggregation. However, pursuant to Commission rules, Sierra cannot offer competitive service in the Class A member distribution cooperatives' service area until the Commission has deemed those areas open to competition.

19. Sierra will be a taxable cooperative because, initially, the bulk of its income will come from its staffing services rather than the sale of electricity.

20. The application requested approval to transfer the transmission portion of AEPCO's CC&N to Southwest. After closing, Southwest will immediately generate revenues from AEPCO's

Class A members and others. The employees who will operate Southwest's transmission system are currently the AEPCO employees who operate the same transmission system. For these reasons, Staff believes that Southwest is a fit and proper entity to receive the transmission portion of AEPCO's assets and CC&N and recommends that the Commission approves the transfer.

Financing Issues

21. AEPCO's financial health has steadily improved since 1995. Except for the $6.7 million write-off of the PPFAC bank balance and $4.1 million shortfall charge-back expense related to sales to California, AEPCO's net margins (equivalent to net profit for an investor-owned utility) in 2000 would have been the highest in six years. Long-term debt has steadily declined, while membership capital (equivalent to "common equity" for investor-owned utilities) steadily increased and turned positive in 2000 for the first time in many years. Interest expense has also steadily declined over the six years. The balance of AEPCO's Cash and Cash Equivalents account, which represents cash and investments that are readily converted to cash, was $49.0 million at December 31, 2000.

22. The application also requested approval for AEPCO and Southwest to execute notes, mortgages and assumption and indemnity agreements associated with the restructuring. These will be necessary for the transfer of some of AEPCO's debt to Southwest

23. Any debt assumed by or transferred to Southwest from AEPCO wi'l be issued at identical interest rates and maturities as the debt presently carries. Because the amount of debt to be assumed or replaced by Southwest will not be known precisely until the close of the transaction, the Cooperatives have requested that approval for Southwest to execute notes, mortgages and assumption and indemnity agreements be for a total amount of up to $100.0 million. Also, AEPCO will need approval to issue replacement notes for the debt that they are retaining.

24. None of the debt for which approval is requested is "new" debt. The total will sum to AEPCO's debt immediately before closing. Staff believes that these debt transactions are necessary to effectuate the restructuring. Because Southwest's transmission rates and AEPCO's rates for generation are set to equal their revenue requirement and the debt service related to the assumed debt is part of that revenue requirement, Southwest and AEPCO should have the ability to make principal and interest payments on the assumed debt. If the restructuring is approved, Staff recommended

approval for AEPCO and Southwest to execute notes, mortgages and assumption and indemnity agreements in an amount not to exceed AEPCO's debt immediately before closing.

25. AEPCO and Southwest will make cash capital contributions to Sierra in the amount of $4.0 million to enable its formation. Because substantially all of AEPCO's assets are subject to the Rural Utility Services ("RUS") and the National Cooperative Financing ("CFC") mortgages, AEPCO is seeking a release of the Sierra business and assets from the mortgages

26. The Restructuring Agreement executed by AEPCO, Southwest and Sierra provides that Sierra will be financed through capital contributions of $4.0 million from Southwest and AEPCO. Sierra has also applied for credit support in the amount of $500,000 from the National Rural Utilities Cooperative Finance Corporation ("CFC"). The funds from AEPCO, Southwest and the CFC will be used primarily to cover a thirty to forty-five day lag between the generation of revenue and the payment of payroll.

27. AEPCO currently has a balance of approximately $200.0 million in RUS and RUS guaranteed debt. To protect its interests in being repaid in a timely manner, the RUS imposed restrictions that AEPCO and Southwest must follow in the restructuring. One condition is the retention by AEPCO of the existing bundled sales contracts between AEPCO and the Class A all-requirements members.

28. The RUS also limited Sierra's control over the activities of AEPCO and Southwest because RUS will have no control over Sierra. The purpose of this restriction is to ensure that AEPCO and Southwest's margins are not appropriated by Sierra compromising their ability to make timely debt payments to RUS.

29. Final RUS approval of the notes and replacement debt will occur after AEPCO and Southwest have received Commission approval.

FERC

30. On April 11, 2001, Sierra and Southwest filed an application with FERC relating to the restructuring of AEPCO. Sierra requested FERC authorization of a rate schedule for the wholesale sale of electric energy and capacity at market-based rates and for authorization for the Resource Integration Agreement which governs some of Sierra's wholesale power sales. Sierra also requested

that FERC issue a declaratory order disclaiming jurisdiction over AEPCO and Southwest because of they have RUS and RUS guaranteed debt. Southwest requested that FERC make a finding that Southwest's Open Access Transmission Tariff is an acceptable reciprocity tariff and that its proposed Standards of Conduct satisfy the standards required by FERC Order No. 889. On May 30, 2001, without a hearing or suspension, FERC issued an order approving Sierra's and Southwest's applications.

Code of Conduct

31. AEPCO has requested approval of a Code of Conduct between itself and Sierra and between the Class A members and Sierra. These Codes of Conduct were submitted to comply with A.A.C. R14-2-1616. However, AEPCO contends that the Code of Conduct rules do not apply and, therefore, AEPCO requested waivers from these rules or, in the alternative, approval of the Codes of Conduct as proposed.

32. Although the three entities will have separate functions and each will have its own Board of Directors, the Boards will primarily be chosen from the same pool of individuals from which AEPCO's current directors originate.

33. In the restructured company, Sierra will perform several roles, which includes an overlap of roles in both the wholesale and retail markets. However, Sierra's role as a wholesale and retail marketer are not addressed in the proposed Codes of Conduct.

34. The market power study submitted to FERC by Southwest and Sierra reports that Sierra will provide personnel to fill non-core positions at AEPCO and Southwest. Staffing agreements will govern the functions of and payments for these employees. AEPCO and Southwest will provide management directives, policies, and supervision of Sierra's employees. The Sierra employees assigned to Southwest will be subject to the OASIS Standards of Conduct. Thus, structurally, Sierra employees will not have operational control over the activities of AEPCO or Southwest.

35. Sierra, as an electric service provider, will work in conjunction with the member distribution cooperatives, which are rate regulated utilities, through a Joint Marketing Agreement. For the other utilities in the state, a separation of the competitive provider and the utility is required.

. . .

AEPCO contends that if it can not offer the competitive services through this arrangement, the services will likely not be provided at all in the rural regions of the state.

36. AEPCO has asserted that it will comply with the FERC's rules, procedures and guidelines concerning the separation of the merchant and power marketing functions of an electric utility from its transmission functions and that appropriate standards of conduct will be followed to ensure adequate separation. AEPCO contends that the member owned corporate structure of the cooperatives minimizes Code of Conduct concerns because any margins in either market will accrue to the members.

37. AEPCO, its affiliates and the member distribution cooperatives are member owned and they serve a region of the state that would likely not be profitable enough for others to service is a factor in Staff's recommendation that the Commission approve the Code of Conduct at this initial stage.

38. Staff also recommended that the Commission reserve the right to impose additional restrictions if problems arise or if the demand for competitive services becomes larger than anticipated and would support other service providers in the rural regions of the state.

39. These issues should be re-examined in AEPCO's and Southwest's next rate case.

Partial Requirement Contract

40. AEPCO has also requested the approval of a Partial Requirement Capacity and Energy Agreement with Mohave. As part of the restructuring, Mohave, AEPCO's largest Class A member, would convert from a full requirement member to a partial-requirement member.

41. Mohave would pay for electric service based upon a three-part charge, consisting of a fixed charge, charges based on an Operations and Maintenance rate and an energy rate charge. The fixed charge represents Mohave's share of AEPCO's debt payments and is instrumental in receiving RUS approval.

42. The restructuring will also provide the five remaining Class A, full requirement members the opportunity to seek to become partial requirements customers in the future pursuant to separate conversion agreements that would be subject to approval of the RUS.

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43. AEPCO will supply Mohave power and energy based on its historic demand and investment. However, Mohave will be free to procure its additional needs from other sources.

44. Because Mohave will only participate in the wholesale market for its incremental needs, the recent volatility in electric prices should present a minimal risk. In return, the partial requirement arrangement provides Mohave the opportunity to pursue advantageous pricing arrangements as the wholesale market matures and becomes less volatile and chaotic. Therefore, the Partial Requirements Capacity and Energy Agreement should be approved.

Purchased Power and Fuel Adjustor Clause

45. The fundamental rationale for a fuel adjustment clause is that fuel prices can change radically based on the overall energy market. During much of the time that AEPCO's restructuring was being planned, fuel prices were dropping. During the more recent past, there has been a dramatic reversal of that trend. It is likely that for at least the near future, energy prices will be unstable.

46. Purchased power and fuel adjustor clauses for Arizona utilities may be created and set during a rate case wherein a base cost of fuel and purchased power is determined and included in base rates. The base period cost of fuel and purchased power adopted in AEPCO's last rate case and used in the subsequent fuel adjustor filings is $0.01714 per kWh. AEPCO's most recent filing of its fuel and purchased power cost adjustment indicated that its current cost of fuel and purchased power is $0.026034.

47. AEPCO's application requested that the Commission's approval to: (1) forgive the under-collected balance in its PPFAC bank as of the effective date of the restructuring and (2) to eliminate its PPFAC on an on-going basis."

48. As of December 31, 2000 AEPCO's PPFAC bank balance was undercollected by approximately $6.7 million. Between January 1 and March 31, 2001, AEPCO has accumulated an additional undercollected balance of $2.3 million.

49. Staff has not audited the cumulative expenses included in AEPCO's reported undercollected PPFAC balance in several years. Staff cannot confirm the amount undercollected without a complete audit of the historical PPFAC filings, accounting and related invoices.

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50. Staff has recommended that the Commission approve, nunc pro tunc, the write-off of the December 31, 2000 PPFAC, undercollected balance of $6.7 million.

51. Staff also recommended that the Commission order that a new docket be opened in which to examine the PPFAC. Within the docket, Staff would perform an audit of the PPFAC filings to verify the balance and to verify AEPCO's compliance with previous Commission orders. Staff would make recommendations to the Commission as to the appropriate amount of the write-off and whether the adjustor should be continued or eliminated.

Rates

52. AEPCO also requested approval of rates for its Class A members. AEPCO's current rates to its Class A members were set by Decision No. 58405, dated September 3, 1993. The rates set were bundled rates of $15.25 per kW of billing demand plus $0.0228 per kWh. AEPCO's original restructuring application requested approval of a tariff that represented a rate reduction to its Class A members. AEPCO's amended application requested approval of a tariff that was designed to result in no change in the Class A members' total power bills.

53. AEPCO's amended application also requested that the rates for generation charged to its all requirements Class A members be set at $12.44 per kW of billing demand plus $0.01989 per kWh. Southwest's rates for transmission for Class A members and for all other parties are set forth in its Open Access Transmission Tariff ("OATT"), which has already received FERC approval. The OATT rates include a monthly demand charge determined by multiplying proportion of the customer's load to Southwest's load by one-twelfth of Southwest's annual revenue requirement. According to the OATT, Southwest's revenue requirement for network integration transmission service is $13.4 million, "effective until amended by Southwest." This translates into initial transmission rates of $3.244 per kW per month.

54. Although the total of the generation and transmission demand rates of $12.44 and $3.244, respectively, equals $15.684 per kW and exceeds the bundled demand rate of $15.25 per kW, the new kWh charge of $0.01989 is less than the bundled kWh charge of $0.0228. When the unbundled rates are applied to the Class A members' bills for the twelve months ending December 31, 2000, the resulting pro forma power bills were $1.0 less than the actual total power bills during 2000.

On an individual basis, the pro forma power bills of the Class A members all were less than their actual bills. Thus, the impact on all of the Class A members, all factors held constant, should be that their power bills will be slightly lower than they would have been under the old, bundled rates.

Future Rate Case

55. Although AEPCO expects some cost savings through Sierra's provision of centralized services, some costs may increase under the proposed restructured organization. The cost of the reorganization itself and the costs of educating, transporting and housing three Boards of Directors are costs that may increase.

56. Decision No. 58405 required that AEPCO to conduct a fully allocated embedded cost of service study in conjunction with its next rate filing.

57. Staff has recommended that the Commission order AEPCO and Southwest to each file a rate case eighteen months after the closing of the restructuring for the following reasons: to insure that asset and liability allocations among the three entities have been performed in a fair and equitable manner; to insure that the ultimate customers of AEPCO benefit from any cost savings from the restructuring; to insure that AEPCO's and Southwest's rates are fair and reasonable; to determine if the allocations among the three entities were reasonable; and to determine if the restructured cooperatives were experiencing savings from the restructuring that exceed the costs.

58. A rate case that would be filed 18 months after the restructure has occurred would encompass one year of operations under the new structures and provide the cooperatives an appropriate amount of time to close the books and to prepare a rate case submission.

Notice

59. AEPCO's member cooperatives have received notice and agree to AEPCO's application.

60. AEPCO published notice of the Application in the Daily Star and in Kingman and Sierra Vista newspapers.

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Recommendations

61. Staff recommended approval of the restructuring and the transactions to effectuate the restructuring. However, because of the many issues raised by this application and the volatility of the energy market, there are several conditions that should be attached to the Decision in this matter.

62. Staff recommended approval of the forgiveness of the December 31, 2000 undercollected PPFAC balance. However, Staff also recommended that the Commission authorize Staff to opened a docket and request a procedural order be issued within 90 days from the decision in this docket. The purpose of the docket would be to examine AEPCO's PPFAC. Staff would perform an audit of AEPCO's PPFAC filings and balance to verify the balance and verify AEPCO's compliance with previous Commission orders. At that time Staff will also make a recommendation regarding the continuation or discontinuation of the PPFAC and a recommendation regarding the balance forgiven.

63. Staff recommended that the Commission order that both the new AEPCO and Southwest file rate cases eighteen months from the closing of the restructuring. In the rate applications, AEPCO and Southwest should include an analysis of the savings and benefits enjoyed from the formation of Sierra that would not have been experienced without the restructuring and include a cost of service study as ordered by Decision No. 58405.

64. Staff recommended that the Commission reserve the right to impose additional restrictions on Sierra at the time of AEPCO and Southwest's next rate case if problems arise regarding Sierra's role as a wholesale purchaser and a cooperative service provider, or if the demand for competitive services becomes larger than anticipated and would support other service providers in the rural regions of the state.

65. Staff recommended that the Commission require Southwest to obtain any necessary franchises and file them in this docket when obtained.

66. Staff recommended that the Commission find that to the extent A.A.C. R14-2-1615 applies to a generation and distribution cooperative, this restructuring complies with that rule.

67. Staff recommended approval of the transfer of AEPCO's transmission assets to Southwest and certain assets to Sierra.

. . .

68. Staff recommended approval of the transfer of the transmission portion of AEPCO's CC&N to Southwest.

69. Staff recommended approval of the execution by AEPCO and Southwest of notes, mortgages and assumption and indemnity agreements associated with the restructuring, the total not exceeding AEPCO's outstanding debt immediately previous to the time of closing.

70. Staff further recommended approval of the partial requirements relationship between AEPCO and Mohave, with the final executed agreement to be filed with the Commission upon completion of the restructuring. Such relationship should not differ materially from that described in the Application and its exhibits and schedules.

71. Staff recommended approval of the revised Class A member all requirement tariff attached as Exhibit C to the Amended Application.

CONCLUSIONS OF LAW

1. AEPCO is an Arizona public service corporation within the meaning of Article XV, Section 2, of the Arizona Constitution.

2. The Commission has jurisdiction over AEPCO and over the subject matter of the Application.

3. The Commission has reviewed the Application, Staff's Memorandum and the Staff Report and has determined that Southwest is a fit and proper entity to purchase AEPCO's assets and receive the transmission portion of AEPCO's CC&N. The Commission has also determined that the transfer of assets from AEPCO to Sierra is in the public interest and the proposed financing transactions are compatible with sound financial practices and are in the public interest. The Commission has also determined that the rates set forth in the tariff filed in with the application are just and reasonable.

4. The Commission has determined that Staff's recommendations, set forth in Findings of Fact Nos. 61-71, are in the public interest and should be adopted.

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ORDER

IT IS THEREFORE ORDERED that the Commission hereby approves AEPCO's application consistent with Staff's recommendations listed in Findings of Fact Nos. 61-71.

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

BY ORDER OF THE ARIZONA CORPORATION COMMISSION

CHAIRMAN	COMMISSIONER	COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Secretary of the Arizona Corporation Commission, have hereunto, set my hand and caused the official seal of this Commission to be affixed at the Capitol, in the City of Phoenix, this _________ day of ______________, 2001.

____
BRIAN C. McNEIL
Executive Secretary

DISSENT: _______________________

DRS:LAJ:mai

SERVICE LIST FOR: ARIZONA ELECTRIC POWER COOPERATIVE, INC.
DOCKET NO. E-01773A-00-0826

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