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REHEARING RECEIVED OCT 21 2002

BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission

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WILLIAM A. MUNDELL
Chairman
JIM IRVIN
Commissioner
MARC SPITZER
Commissioner

SEP 30 2002

AZ CORP COMMISSION
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IN THE MATTER OF THE GENERIC PROCEEDINGS CONCERNING ELECTRIC RESTRUCTURING

DOCKET NO. E-00000A-02-0051

IN THE MATTER OF ARIZONA PUBLIC SERVICE COMPANY'S REQUEST FOR VARIANCE OF CERTAIN REQUIREMENTS OF A.A.C. 4-14-2-1606

DOCKET NO. E-01345A-01-0822

IN THE MATTER OF THE GENERIC PROCEEDING CONCERNING THE ARIZONA INDEPENDENT SCHEDULING ADMINISTRATOR

DOCKET NO. E-00000A-01-0630

IN THE MATTER OF TUCSON ELECTRIC POWER COMPANY'S APPLICATION FOR APPROVAL OF ITS STRANDED COST RECOVERY

~~DOCKET NO. E-01933A-98-0471~~

ISSUES IN THE MATTER OF TUCSON ELECTRIC POWER COMPANY'S APPLICATION FOR A VARIANCE OF CERTAIN ELECTRIC COMPETITION RULES COMPLIANCE DATES

DOCKET NO. E-01933A-02-0069

ARIZONA PUBLIC SERVICE COMPANY'S APPLICATION FOR REHEARING OF DECISION NO. 65154

Pursuant to A.R.S. § 40-253, Arizona Public Service Company ("APS" or "Company") hereby submits this Application for Rehearing and Reconsideration of Decision No. 65154 (September 10, 2002) (the "Decision"). For the reasons set forth

1 below and in the Company's August 1, 2002 Exceptions to the Recommended Order,
2 which are incorporated herein by this reference and attached as Appendix A, the Decision
3 is unreasonable, unlawful, and constitutes a breach of the 1999 Settlement Agreement
4 ("Agreement") that was approved in Decision No. 61973 (October 6, 1999). Accordingly,
5 APS respectfully requests that the Arizona Corporation Commission ("Commission")
6 grant this Application and modify Decision No. 65154 accordingly.

7
8 **I.**
9 **INTRODUCTION AND GENERAL GROUNDS**
10 **FOR REHEARING AND RECONSIDERATION OF THE DECISION**

11 In October 2001, APS requested that the Commission approve a partial variance to
12 Rule A.A.C. R14-2-1606(B), to allow APS to enter into a cost-based purchase power
13 agreement with Pinnacle West Capital Corporation ("PWCC") to address potential
14 concerns over the wholesale electric market. After that request was tabled without a
15 hearing, APS proposed that certain Pinnacle West Energy Corporation ("PWEC")
16 generation assets—which were constructed outside of APS due to requirements in the
17 Electric Competition Rules and Code of Conduct and in reliance on the promised
18 divestiture of APS generation to PWEC as provided in the Agreement—be acquired by
19 APS without prejudging the eventual rate-base treatment of such generation if divestiture
20 to PWEC was not allowed. Such relief was necessary because PWEC would never have
21 constructed that generation without the divestiture promised in the Agreement as PWEC's
22 investment-grade debt ratings were contingent on it acquiring the APS generation.
23 Throughout the proceeding, APS took the position that, if the Commission determined
24 that the public interest did not warrant either alternative, APS would comply with the
25 Electric Competition Rules as written and the Agreement. However, none of APS'
26 proposals for addressing the Commission's concerns over retail electric competition were
accepted in Decision No. 65154.

1 approved the Agreement, conferred upon APS the legal permission to divest its assets to
2 PWEC and, as such, constituted a licensing decision in addition to being a binding
3 contract. The Decision cannot now revoke that license and impose new conditions and
4 limitations on APS' ability to divest its generation without completing another rulemaking
5 that specifically authorizes the revocation and new conditions. *See* A.R.S. § 41-1030(B)
6 ("An agency shall not base a licensing decision in whole or in part on a licensing
7 requirement or condition that is not specifically authorized by statute, rule or state tribal
8 gaming compact.").

9
10 **V.**
THE DECISION VIOLATES THE SUPREMACY
CLAUSE OF THE UNITED STATES CONSTITUTION

11 The Commission lacks jurisdiction to take action based on state findings relating to
12 market power in wholesale electric markets. Such jurisdiction resides solely with FERC,
13 which has already determined that APS and its affiliates do not have market power or
14 have adequately mitigated market power in the APS service area. Those findings preempt
15 the Commission under the Supremacy Clause of the United States Constitution and
16 applicable federal authority. *See, e.g., PSEG Power Cross Hudson*, 100 FERC ¶ 61,162
17 (Aug. 5, 2002).

18
19 **VI.**
THE DECISION IS NOT SUPPORTED
BY ADEQUATE FINDINGS AND CONCLUSIONS

20 The findings of fact and conclusions of law contained in the decision do not
21 adequately support the result of the Decision as required by A.R.S. § 41-1063 and general
22 principles of constitutional due process. For example, the Decision includes findings of
23 fact relating to changed circumstances, but the Decision does not articulate how such
24 changed circumstances, even if true, justify the unilateral modification of the Agreement.
25 The findings and conclusions do not articulate why the public interest in honoring
26

1 contracts should be rejected in favor of the public interest requiring the revocation of
2 divestiture authority, or why FERC's determinations on market power issues relating to
3 APS and its affiliates were rejected in this proceeding. Also, the findings and conclusions
4 do not explain why APS would be subject to Rule 1606(B) as it would not be a Utility
5 Distribution Company and do not sufficiently explain why a new Code of Conduct
6 requirement is either necessary or appropriate.

7
8 **VII.**
9 **THE DECISION VIOLATES APS' DUE PROCESS RIGHTS**
10 **UNDER THE ARIZONA AND UNITED STATES CONSTITUTIONS**

11 The Decision violates APS' rights to due process of law under the 5th Amendment
12 of the United States Constitution, as applied to the states through the 14th Amendment,
13 and under Article II, Section 4 of the Arizona Constitution. For example, the Decision
14 violates substantive due process because it is unreasonable, arbitrary and capricious, and
15 the means selected in the Decision lack a real and substantial relation to the goals asserted
16 in the Decision. Further, the Decision violates procedural due process because the
17 Commission failed to provide for a hearing on alternatives that would have allowed the
18 Commission to comply with the Agreement while still addressing the goals asserted in the
19 generic review of the Electric Competition Rules. As a result of the Decision, generation
20 built by PWEC due to requirements in the Electric Competition Rules and presently
21 dedicated to service to the public is now bifurcated from and denied the constitutionally-
22 required regulatory and financial treatment necessarily afforded to APS generation.

23 **VIII.**
24 **THE MARKET POWER STUDY AND**
25 **CODE OF CONDUCT REQUIREMENTS IN THE DECISION ARE UNLAWFUL**

26 The Decision requires APS to submit vaguely-described and likely unachievable
market power studies prior to seeking authorization to divest generation. The Decision
also requires APS to submit a Code of Conduct with parameters that are not adequately

1 defined or explained. In addition to the market power studies being preempted by federal
2 law and FERC authority as discussed above, the study and filing requirements in the
3 Decision are too burdensome and vague to allow APS a meaningful opportunity to meet
4 such requirements or to challenge their applicability. Such requirements also must be
5 promulgated through a rulemaking proceeding and not a generic proceeding.

6
7 **IX.**
8 **THE DECISION VIOLATES APS' EQUAL PROTECTION**
9 **RIGHTS UNDER THE ARIZONA AND UNITED STATES CONSTITUTIONS**

10 The Decision unreasonably discriminates against APS without rational basis in
11 violation of the 14th Amendment of the United States Constitution and Article II, Section
12 13 of the Arizona Constitution. For example, the Decision treats generation constructed by
13 PWEC to meet the reliability needs of APS customers, which generation was constructed
14 at PWEC in reliance on the Electric Competition Rules, differently from generation
15 owned by APS and constructed for the same purpose. The Decision also treats APS,
16 which has no surplus generation, separately from and adversely to Tucson Electric Power
17 Company because the latter has, at present, surplus generation, and other electric utilities
18 subject to Rule 1606(B). The Decision does so without rational basis.

19 **X.**
20 **THE DECISION RESULTS IN AN UNCOMPENSATED**
21 **AND UNCONSTITUTIONAL TAKING OF PROPERTY**

22 The United States Constitution and the Arizona Constitution prohibit the taking of
23 private property without just compensation. The Decision results in an unconstitutional
24 taking of property because, among other things, APS and its affiliates had reasonable,
25 investment-backed expectations that the Commission would honor the Agreement or
26 otherwise provide suitable restitution for the breach of such Agreement. As a result of the
Decision, APS and its affiliates have been damaged at least as described in Section III,

1 above. These damages are recoverable as damages resulting from an uncompensated
2 taking.

3
4 **XI.**
THE DECISION IMPAIRS VESTED CONTRACT RIGHTS

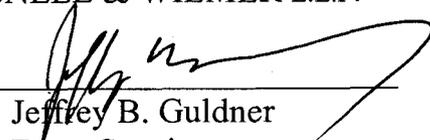
5 Article I, Section 9 of the United States Constitution and Article II, Section 25 of
6 the Arizona Constitution prohibit the state from impairing obligations of a contract. The
7 Decision violates these constitutional provisions by unilaterally amending the Agreement
8 and revoking vested contract rights.

9
10 **XII.**
CONCLUSION

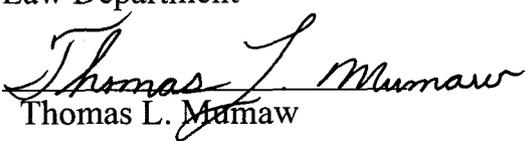
11 The Decision is unreasonable and unlawful for the reasons set forth in this
12 Application. Based upon the foregoing, the Commission should grant APS' Application
13 for Rehearing, vacate Decision No. 65154, and conduct such further proceedings as are
14 appropriate to address the issues raised herein.

15 RESPECTFULLY SUBMITTED this 30th day of September, 2002.

16 SNELL & WILMER L.L.P.

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18 Jeffrey B. Guldner
19 Faraz Sanei

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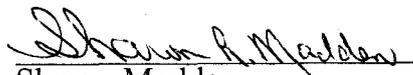
24 Attorneys for Arizona Public Service Company
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26

1 Original and 18 copies of the foregoing
2 filed this 30th day of September, 2002, with:

3 Docket Control
4 Arizona Corporation Commission
5 1200 West Washington
6 Phoenix, AZ 85007

7 Copies of the foregoing mailed, faxed or
8 transmitted electronically this 30th
9 day of September, 2002, to:

10 All parties of record

11 
12 Sharon Madden
13 1243897.1

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A

EXCEPTION

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BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL

Chairman

JIM IRVIN

Commissioner

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IN THE MATTER OF THE GENERIC
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ISSUES IN THE MATTER OF TUCSON
ELECTRIC POWER COMPANY'S
APPLICATION FOR A VARIANCE OF
CERTAIN ELECTRIC COMPETITION RULES
COMPLIANCE DATES.

DOCKET NO. E-01933A-02-0069

EXCEPTIONS OF ARIZONA PUBLIC SERVICE COMPANY TO THE RECOMMENDED OPINION AND ORDER ON "TRACK A" ISSUES

Pursuant to A.A.C. R14-3-110, Arizona Public Service Company ("APS" or
"Company") hereby submits its Exceptions to the Recommended Opinion and Order
("Recommended Order") filed by the Arizona Corporation Commission's

1 (“Commission”) Chief Administrative Law Judge (“ALJ”) on July 23, 2002. Such
2 Recommended Order would, if adopted, constitute a material breach of the 1999 APS
3 Settlement Agreement (“Settlement” or “Agreement”), previously approved and joined by
4 the Commission in Decision No. 61973 (October 6, 1999). It further compounds that
5 error by failing to take or even propose any ameliorative action as was suggested by the
6 Company in its April 22nd Motion and most recently in a letter to the Commission in this
7 Docket dated July 11, 2002. Included in both these filings, and as further explained by the
8 oral testimony of Company President, Jack E. Davis, at hearing, was a suggestion that
9 APS acquire the Pinnacle West Energy Corporation (“PWEC”) assets serving APS load
10 (“PWEC Reliability Assets”), which in turn may require additional financing authority
11 from the Commission.

12 The Recommended Order is also unreasonable and unlawful for the following
13 additional reasons:

- 14 (1) In applying an ill-defined and one-sided “public interest” standard, the
15 Recommended Order ignores the adverse impact of any Commission
16 decision to delay or prevent divestiture of APS generating units to
PWEC as presently authorized by Decision No. 61073 (October 6,
1999) and A.A.C. R14-2-1615 (A) [“Rule 1615(A)”].
- 17 (2) The Recommended Order improperly bases its conclusions on an
18 unsupported finding of unmitigated market power attributable to APS
and PWEC.
- 19 (3) The Recommended Order would require APS to submit a new Code of
20 Conduct that is itself unnecessary or at the very least premature, and
21 which might also conflict with the results of a proceeding presently
before the Federal Energy Regulatory Commission (“FERC”) on this
same subject.
- 22 (4) The Recommended Order’s transmission requirements are ambiguous
23 and confusing, and thus will require clarification in a subsequent
rulemaking or similar proceeding if they are to be implemented by APS
24 and Tucson Electric Power Company (“TEP”).
- 25 (5) The Recommended Order both misstates the “Jurisdictional Issue”
26 related to divestiture and the Company’s position thereon, as well as
not fully addressing possible concerns about the jurisdictional
implications (if any) of not-for-profit versus for-profit RTOs.

1 (6) The Recommended Order effectively or explicitly amends or rescinds
2 prior Commission Orders without having afforded APS notice and
3 hearing as required by A.R.S. § 40-252.

4 SUMMARY OF APS' POSITION

5 APS entered into the 1999 Settlement Agreement in good faith. It has fulfilled
6 every promise it made in that Agreement, including giving over \$600 million in rate
7 reductions, taking a \$234 million write-off, and expending many millions of dollars more
8 to implement the Electric Competition Rules, including but not limited to preparing for
9 the divestiture of all of its generation plants to PWEC.¹ Moreover, PWEC has invested
10 over a billion dollars in generation needed to reliably serve APS customers. PWEC would
11 not have made any of that investment without the Commission's promise that PWEC
12 would receive the Company's existing generation by the end of 2002. Indeed, PWEC
13 could not have done so because PWEC's own credit is contingent upon such divestiture
14 by APS, and Pinnacle West Capital Corporation's ("Pinnacle West") interim or "bridge"
15 financing of this new construction was similarly premised on divestiture. That is not to
16 say that these new generating plants would not have been built, but instead that they
17 would have built by APS rather than PWEC² and thus clearly would have come within the

18 ¹ These other efforts include, but are not limited to, the development of new billing software and
19 operational protocols to accommodate direct access and Commission-mandated rate unbundling, the
20 implementation of a Commission-approved retail Code of Conduct and subsequent training thereon of
21 over 2000 APS management and supervisory personnel, the funding and support for the Arizona
Independent Scheduling Administrator and the Desert Star and WestConnect RTOs, the maintenance of
then-existing low income programs, and the withdrawal with prejudice of litigation against the
Commission and the corresponding write-off of the costs of such litigation.

22 ² The combined effect of Rule 1615(A) and Decision No. 62416 (April 3, 2000), both of which
23 would now be amended or stayed by the Recommended Order, prevented APS from constructing new
24 generation in the period between April 2000 and the end of 2002, even if needed to reliably serve
25 customers. Indeed, the implicit assumption in the Electric Competition Rules (which were silent on the
26 issue of supply generation reliability) was that no new generation would need to be constructed or
obtained by the Affected Utilities between 1999 and the end of 2002. Yet somebody had to step in, and
PWEC's ability to do so in the form of the PWEC Reliability Assets was expressly premised upon the
consolidation of these Assets with the Company's existing generation no later than the end of 2002. Of
course, APS could have contracted for the new supplies it needed last summer, this summer, and

1 definition of the Company's "existing assets," as used in the Recommended Order.
2 (Recommended Order at 32.)

3 To now selectively and unilaterally amend that Settlement without any mention of
4 the need and the obligation of the Commission to address the Company's detrimental
5 reliance on the Settlement—a reliance which now leaves both PWEC and Pinnacle West
6 in the perilous financial situation discussed both by APS witness Jack Davis and in
7 William Post's letter to the Commission dated July 11, 2002 ignores any balanced notion
8 of "public interest." Indeed, it flies in the face of the Recommended Order's own
9 admonition that the Commission should "take action in a manner that is fair to all parties"
10 and that will "minimize the effects" of altering the Settlement. (*Id.* at 22.)

11 The Commission's choice is clear. It must either honor the Settlement that it
12 approved, joined and defended against multiple appeals, or it must take steps to undo the
13 significant harm caused by the breach of the Settlement. Simply put, APS must be
14 permitted to acquire the PWEC Reliability Assets and provide them with long-term
15 financing until the divestiture issue is finally and permanently resolved. This is the first
16 and most essential step towards a compromise that will reconcile the promises made in the
17 Settlement with the "change of circumstances" claimed in the Recommended Order.

18 Additionally, although less global in its implications to the Company and its
19 affiliates, the Recommended Order makes findings of market power that are wholly
20 unsupported by credible evidence, are unnecessary in any event, and which could be used
21 to the detriment of the Company and its customers in future proceedings. The "market
22 power study" the Recommended Order would require as a precondition to divestiture is so
23 undefined as to be largely without value and is apparently pointless in any event because
24 the "study" appears to presuppose the existence of market power even before it is

25 succeeding summers, but the cost of obtaining such supplies during the volatile days of 2000-2001 would
26 have been prohibitive. And, although West Phoenix and Redhawk would no longer be at issue, the
Company and its customers would have been saddled with a 10-20 year contract at far higher costs.

1 conducted. The Recommended Order also proposes imposition of a new Code of Conduct
2 before it is clear that such a document is actually necessary. This is especially true given
3 similar proceedings pending before FERC and the real potential that PWEC would no
4 longer be in the position of being a significant seller of power to APS, should APS acquire
5 the PWEC assets presently serving APS or under construction for that purpose. The
6 Recommended Order further requires APS and TEP to “develop a plan” and to “file [a]
7 reliability must-run study” (*id.* at 32), while not clearly articulating what the “plan” is
8 supposed to address and under what circumstances the “study” is to be required. Finally,
9 the Recommended Order misses the point on the second “jurisdictional issue” that the
10 Company believes was raised during the hearing and partially misstates the Company’s
11 position on both such issues in any event.

12 INTRODUCTION

13
14 On page 1, the Recommended Order begins its discussion by noting the
15 Company’s filing of a request for variance in October of 2001. It is as if that filing was
16 somehow the cause of or even substantially related to the expansive re-examination of the
17 Settlement and the Electric Competition Rules called for in Track A of the instant generic
18 proceeding. It was not. Back in October of 2001, APS asked for one variance to one
19 provision of many of the Electric Competition Rules. APS did so for one singular
20 purpose—to request approval of a proposed purchase power agreement (“Proposed PPA”)
21 between itself and Pinnacle West Capital Marketing & Trading (“PWM&T”) because
22 APS believed and continues to believe that such an agreement was in the best interests of
23 its Standard Offer customers. APS did not volunteer to surrender any right explicitly
24 granted by the Settlement independent of the Electric Competition Rules, such as the clear
25 and unconditional right of APS to divest its generation to PWEC, nor did it ask to be
26

1 relieved of any obligation explicitly imposed by the Settlement independent of the Electric
2 Competition Rules, such as the obligation to grant five annual rate decreases.

3 The Company's variance request, despite its merits, effectively died on April 25,
4 2002. It was killed without allowing so much as a single witness to testify in its defense. It
5 is disingenuous to suggest, as does the Recommended Order at page 24, that the Company
6 somehow brought about its own dilemma or that there is some legal equivalence between
7 the Company's request for a variance to a Rule only incorporated by reference into the
8 Settlement (and which Rule the Settlement by its own terms specifically permitted the
9 Commission to vary or amend) and the Commission's action to unilaterally violate rights
10 expressly granted to the Company in the Settlement—rights that exist independent of Rule
11 1615(A) or any of the Commission's Electric Competition Rules.

12 Rather than try to blame the Company for the Recommended Order's desire to
13 unilaterally abrogate one part of a comprehensive agreement, the Recommended Order's
14 (and the Commission's) focus should now more properly be on the question of where we
15 go from here. On July 11, 2002, the Company explained an earlier suggestion of April
16 22nd that, although not fully compensating APS for the breach of the Settlement
17 Agreement, would in essence stop any further immediate harm to the Company and its
18 affiliates and clear the way for future discussions on how to "unscramble the egg." In its
19 Exceptions, the Company will try to build on this theme of reconciliation in addition to
20 providing the more conventional critique of the Recommended Order.

21 **EXCEPTION NO. 1 – DIVISION OF GENERATING ASSETS SERVING APS**
22 **OR THE "BIFURCATION ISSUE"**

23 It was uncontested at the hearing that APS has incurred millions of dollars in
24 preparing for the transfer of its generation assets by December 31, 2002 as authorized by
25 the APS Settlement and as required by Rule 1615(A). Likewise unchallenged was the fact
26 that APS' affiliates will face increased financing costs and perhaps the inability to either

1 obtain or maintain an investment-grade debt rating so long as the generation assets
2 devoted to serving APS are split into two entities. The Recommended Order misstates the
3 point that APS was making in its Post-Hearing Brief. (See Recommended Order at 12, fn.
4 6.) APS was in fact "required" to form PWEC in order to construct needed generation
5 capacity for APS customers. In other words, the regime that the Commission imposed
6 through the Competition Rules did not itself address reliability and did not permit APS to
7 perform this reliability function itself. In fact, the passage from Decision No. 61973
8 referenced in the Recommended Order was included in the context of justifying why APS
9 was permitted to recover only two-thirds of the costs to transfer generation to the affiliate,
10 not to suggest that APS had any alternative to the creation of PWEC. Thus, the apparent
11 suggestion in the Recommended Order's footnote that it somehow would have been better
12 had APS and its affiliates simply ignored the reliability requirements of APS customers or
13 divested APS generation to a wholly-unaffiliated third party in contradiction to the
14 Settlement or that the current situation of "bifurcation" was somehow the Company's own
15 choice is perplexing to say the least, and wholly irrelevant to the Company's claims of
16 detrimental reliance on such Settlement.

17 And unlike the wholly unsubstantiated claims of the merchant generator
18 intervenors, the Company's detrimental reliance on the Settlement and Rule 1615(A) was
19 both established by record evidence and uncontroverted by any witness. APS' and its
20 affiliates' actions spared its customers from the turmoil and rate shock experienced
21 throughout other parts of the Western United States and has ensured that there is sufficient
22 capacity available to meet APS' reliability requirements last summer, this summer and
23 into the future. Staff witnesses agreed that such increased costs were legitimate claims by
24 APS should Staff's recommended delay, let alone an outright denial of divestiture,
25 eventuate as a result of the Commission's Track A decision. (See Tr. vol. VI at 1347-49;
26 Tr. vol. VII at 1606.) And, as noted above, the Recommended Order itself even posits a

1 desire that the Commission “take action in a manner that is fair to all parties . . .”
2 (Recommended Order at 22.)

3 Despite all of this, the Recommended Order is entirely deficient on how its
4 provisions are or can be “fair” to APS—which has complied with every obligation that it
5 agreed to in the Settlement and commissioned construction of the PWEC Reliability
6 Assets in reliance on the Commission-approved divestiture of APS generation to PWEC.
7 Instead, the Recommended Order proposes simply to change those material provisions of
8 the Settlement that the Recommended Order now finds troublesome. The Recommended
9 Order then glosses over the resulting “bifurcation” issue under the throwaway category of
10 “Miscellaneous Issues.” Although the Recommended Order does suggest that the
11 Company could make “appropriate application(s)” for acquiring the PWEC Reliability
12 Assets (Recommended Order at 25), it makes no specific effort to address or recognize in
13 this proceeding the costs that APS and its affiliates have incurred in detrimental reliance
14 on the Settlement—and certainly evidences no tangible support for actually implementing
15 a solution that is “fair to all parties.”

16 In contrast, APS has suggested, first in its April 22nd Motion and later in its
17 testimony and in the July 11th letter to the Commission in this Docket, one possible and
18 readily-achievable method of resolving the “bifurcation” issue in a manner consistent with
19 the Recommended Order’s expressed desire to be “fair” to the parties—allowing APS to
20 acquire and permanently finance those PWEC assets that were built for APS customers
21 and which would have been built by APS were it not for the divestiture provisions of the
22 Electric Competition Rules (and the associated Commission-mandated Code of Conduct)
23 and the Settlement. Such action would not tie the Commission’s hands as to the future
24 determination of the prudence or “used and useful” inclusion of these assets in the
25 Company’s retail rate base and would at least mitigate the impact of the Recommended
26 Order on APS and its affiliates. As such, “bifurcation,” or more to the point, “re-

1 unification,” is most certainly a Track A issue that should be addressed as part of any
2 order in this proceeding.

3 Accordingly, to achieve the stated objective of being “fair to all parties,” the
4 Recommended Order must be modified to specifically address the “bifurcation” issue. The
5 evidence presented in this proceeding, when properly viewed, supports permitting the
6 divestiture that the Commission has already approved. At a minimum, however, the
7 Commission’s final order on Track A issues should expressly authorize APS to acquire
8 and obtain financing for the generation assets that were built by PWEC for APS’
9 customers without pre-judging any of the factors affecting the eventual rate-making
10 treatment thereof.³ APS has attached a proposed amendment to the Recommended Order
11 in Appendix A to its Exceptions.

12 **EXCEPTION NO. 2 – DIVESTITURE/BREACH OF THE SETTLEMENT**

13 ***A. The Recommended Order, if adopted, would constitute a material breach***
14 ***of the Settlement.***

15 In Decision No. 61973, the Commission entered into a binding agreement with the
16 Company to permit divestiture without further conditions. The Settlement entered into by
17 the Commission specifically granted:

18 all requisite Commission approvals for . . . the creation by
19 APS or its parent of new corporate affiliates . . . and the
transfer thereto of APS’ generation assets ...

20 . . .
21 The Commission has determined that allowing the [APS]
22 Generating Assets to become . . . owned by an APS EWG
affiliate will benefit consumers, (2) is in the public interest,
and (3) does not violate Arizona law.

23 See 1999 APS Settlement Agreement at §§ 4.2 and 4.4 (emphasis supplied).

24 ³
25 APS is aware that it may have to submit a financing application to the Commission if it otherwise
26 lacks sufficient debt authorization under Decision No. 55017 (May 6, 1986) and its predecessor decisions
to accomplish the above acquisition. The financing “approval” referenced above would be only an
approval “in principle” pending such a formal application as is required under A.R.S. § 40-301, *et seq.*

1 In the decision approving the Settlement, the Commission also stated
2 unequivocally that it:

3 supports and authorizes the transfer by APS to an affiliate or
4 affiliates of all its generation and [other] competitive electric
5 service assets as set forth in the Agreement no later than
6 December 31, 2002. [Decision No. 61973 at 10 (emphasis
7 supplied).]

8 ...

9 The terms and conditions of the Settlement Agreement as
10 modified herein are just and reasonable and in the public
11 interest. [Id. at 17, Finding of Fact No. 33 and Conclusion of
12 Law No. 17 (emphasis supplied).]

13 The Arizona Court of Appeals in *Arizona Consumers Council v. Arizona*
14 *Corporation Commission*, 1 CA-CC 99-0006 (Ariz. Ct. App., April 5, 2001) has already
15 conclusively construed the legal meaning of the relevant provisions of the Settlement. In
16 upholding the Settlement, the Arizona Court of Appeals held:

17 The agreement requires APS to divest its generation assets by
18 December 31, 2002, and requires the Commission approve the
19 formation of an APS affiliate to acquire those assets at book
20 value. [Opinion at ¶ 8.]

21 ...

22 Section 6.1 [of the Settlement] makes the Commission a party
23 to the agreement, and section 6.2 precludes the Commission
24 from taking or proposing any action inconsistent with the
25 agreement and requires the Commission to actively defend it.
26 [Opinion at ¶ 33.]

...

The general rule, however, is that a contract that extends
beyond the terms of the members of a public board is valid if
made in good faith and if its does not involve the performance
of personal or professional services for the board. [Citation
omitted.] The [Arizona Consumers] Council has not alleged
that the [settlement] contract was not entered into in good
faith, and the contract does not involve personal services for
Commission members. The [settlement] contract can therefore
bind future commissions. [Citation omitted.] [Emphasis
supplied.] [Opinion at ¶ 38.]

1 The Recommended Order proposes precisely the action that the Court of Appeals
2 has already held the Commission cannot take without breaching the Settlement.⁴ As
3 discussed below, that issue has been decided as between APS and the Commission. The
4 discussion in the Recommended Order that suggests that “if granting a variance from Rule
5 1606(B) would not violate the Settlement Agreement, then granting a stay or variance of
6 [Rule 1615(A)] would similarly not violate the Settlement Agreement” (Recommended
7 Order at 24) is simply incorrect. It ignores the fundamental distinction between those
8 provisions of the Settlement that merely incorporate by reference whatever right or
9 obligation as is imposed by the Electric Competition Rules (e.g., Section 4.1.3’s language
10 on competitive procurement post-divestiture), which Rules the Commission expressly
11 reserved the right to modify (Section 7.1), from those Sections of the Agreement (Sections
12 2.2, 4.2, etc.) that are independent of the Electric Competition Rules, and which therefore
13 cannot be modified unilaterally without breach of the entire Agreement. If the
14 Commission in a final decision had determined that APS’ Request for a Partial Variance
15 constituted a breach of the Settlement, APS would have complied with the Settlement, as
16 thus interpreted, irrespective of Rule 1606(B). The Commission should do no less.

17
18
19 ⁴ The Court of Appeals’ holdings regarding the meaning and impact of the Settlement is binding as
20 a matter of law between the APS and the Commission. *See, e.g., Elec. Dist. No. 2 v. Arizona Corp.*
21 *Comm’n*, 155 Ariz. 252, 259 & n.2, 745 P.2d 1383 (1987) (Arizona Supreme Court holding that the
22 Commission is bound by a final Court of Appeals decision and noting that an unpublished memorandum
23 decision is “just as binding on the parties as a published opinion”). In the litigated appeals to Decision No.
24 61973, the Commission had the opportunity to argue, and in fact argued, its position that the Settlement
25 was not really a contract and did not really bind the Commission. As the quotations from the Court of
26 Appeals’ decision above note, those arguments were expressly rejected. As such, the matter is *res judicata*
and the Commission is bound by the Court’s interpretation. This result—that the Commission is bound to
a settlement agreement that it enters into like any other party—is by no means a novel position in Arizona.
See U S West Comm. v. Arizona Corp. Comm’n, 185 Ariz. 277, 280-82, 915 P.2d 1232 (Ct. App. 1996)
(rejecting attempt by Commission to change settlement agreement that affected rate treatment of U S
West). The Recommended Order fails to consider this legal issue or articulate a lawful reason as to why
the Commission is not bound as the Court of Appeals has found.

1 The Commission should honor the Settlement, just as APS has honored its
2 commitment to take a \$234 million write-off of otherwise recoverable costs, to voluntarily
3 reduce rates by some \$600 million (to date), to dismiss with prejudice its pending
4 litigation against the Commission, and to make the other concessions implicit and explicit
5 in the APS Settlement. No legitimate legal or policy reason to the contrary has been
6 presented in this proceeding or even discussed in the Recommended Order.

7 The Recommended Order also does not discuss less onerous alternatives to
8 breaching the Settlement, such as consideration of the Proposed PPA that APS offered or
9 a similar cost-based agreement covering the APS and PWEC assets. The Proposed PPA
10 would permit the divestiture while both addressing the reliability issue by incorporating
11 the PWEC Reliability Assets and protecting APS customers from the very market risk
12 decried by the Recommended Order (Recommended Order at 22 and Finding of Fact Nos.
13 29 and 35) but to which customers would (ironically) be exposed by the very same
14 Recommended Order. (*Id.* at 23 and Finding of Fact No. 36.) Neither does the
15 Recommended Order address the damage occasioned by its breach as repeatedly urged by
16 the Company as far back as its April 22, 2002 Motion for Determination of Threshold
17 Issue and as recently as the letter from Mr. Post in this Docket of July 11th. The Company
18 has suggested changes to the Recommended Order addressing the latter of these two
19 options (acquisition by APS of the PWEC Reliability Assets) as APS Proposed
20 Amendment No. 1 under Exception No. 1 in Appendix A.

21 ***B. There have been no changes in circumstances justifying a breach of the***
22 ***1999 APS Settlement.***

23 The Recommended Order lists several issues, such as the amount of retail
24 competition active in the state, alleged incumbent market power, and the GAO Report on
25 FERC oversight on competitive markets. It concludes that these issues are changes and
26 “circumstances outside [the Commission’s] control or the control of any party” that

1 warrant the Commission abrogating the Settlement. (Recommended Order at p. 22.)
2 However, none of the issues actually represent a “change” of circumstances since 1999 or
3 are changes irrelevant to the issue of divestiture.

4 Specifically, the lack of active retail competition today is no basis to breach the
5 Settlement because the potential for an Electric Service Provider to offer service should
6 APS Standard Offer service become unattractive itself protects consumers. If the
7 Settlement remains intact, APS customers are protected through June 2004 from
8 wholesale rate impacts, something that makes the GAO Report less significant particularly
9 when coupled with the current effort at FERC to improve its oversight of the wholesale
10 market or when mitigated through the cost-based Proposed PPA. Indeed, FERC’s
11 Standard Market Design Notice of Proposed Rulemaking (“SMD NOPR”) is intended to
12 address precisely those deficiencies cited in the GAO Report. Also, any alleged “market
13 power” held by incumbent utilities is unquestionably less than in 1999 when the
14 Commission approved divestiture without further conditions, so it cannot constitute
15 changed circumstances. Similarly, transmission constraints were present in 1999 and will
16 be present in the future regardless of divestiture. Regardless, the AISA has protocols to
17 address related issues such as must-run generation even in the absence of an RTO. There
18 has been no change in FERC’s regulatory jurisdiction over wholesale power transactions
19 since 1999. Staff has proposed no changes to APS’ existing Code of Conduct or Policies
20 and Procedures since its approval by the Commission in the spring of 2000, nor has APS
21 ever been accused of breaching that Code of Conduct. In any event, given the rate
22 protections afforded to APS customers under the Settlement, there is certainly time to
23 address any Code of Conduct concerns the Commission may have before there would be
24 any impact on APS customers and regardless of whether divestiture takes place as
25 approved in the Settlement.

26

1 As APS noted in its Post-Hearing Brief and in Mr. Davis' testimony, the most
2 significant change in circumstances was the formation of a new and separate generation
3 affiliate as required by the Settlement to accommodate the divestiture. That "change",
4 however, further supports compliance with the Settlement, rather than its abrogation by
5 the Commission. But, even if all of the issues identified in the Recommended Order were
6 accepted as "changes" and had evidentiary support as such, this would at best argue for
7 rescinding or reforming the entire Settlement Agreement rather than selectively breaching
8 the Settlement as proposed in the Recommended Order. The latter approach effectively
9 allocates all of the risk of such "changes" to APS and to no other party. Such a result is
10 inconsistent with the Recommended Order's own conclusion that APS was not at fault for
11 the alleged "changes, and it is neither fair nor lawful.

12 C. *The "public interest" justification given by the Recommended Order for*
13 *abrogating a single portion of the Settlement is unsupported by any*
14 *Arizona regulatory or judicial precedent and is, in any event,*
impermissibly vague and has been improperly and unfairly applied
against just one party to the Agreement.

15 The Recommended Order concludes, without specifically articulating the
16 applicable legal standard, that the "public interest" requires that the Commission breach
17 the Settlement. (Recommended Order at 23.) APS would note at the outset that there is no
18 legal authority in Arizona for the unilateral breach by the Commission of a prior
19 settlement agreement. Even in the *U S West* decision cited above, the Commission
20 attempted to argue that its actions did not constitute a violation of its agreement with the
21 utility rather than claiming some manifest authority to simply disregard its previous
22 promises.

23 The very lack of such precedent speaks volumes about what is, in fact, "in the
24 public interest" under the present circumstances. As discussed throughout the United
25 States Supreme Court's opinion in *United States v. Winstar Corp.*, 518 U.S. 839 (1996),
26 the "public interest" is most directly served by the government keeping its regulatory

1 promises or “making good” to those adversely affected when it cannot. The
2 Recommended Order thus fails the most compelling and authoritative definition of what is
3 “in the public interest.” Indeed, at no point does the Recommended Order explain how
4 any definition of the “public interest” demands that:

- 5 • the breaching party be allowed to keep all the benefits of the very Agreement
6 it has determined to breach
- 7 • the non-breaching party be forced to absorb without compensation all the
8 damages occasioned by the breach
- 9 • the issue of detrimental reliance on the Settlement be entirely unaddressed.

10 Even when the contract at issue is only between private parties and does not
11 implicate the “full faith and credit” of government, it is well recognized that the level of
12 scrutiny and analysis given to a “public interest” justification is significantly more
13 stringent when the abrogation of a contract is at issue, than if parties’ reliance on the more
14 general policy determinations of a regulatory agency, such as rulemakings, are the focus.
15 *See, e.g., Texaco v. FERC*, 148 F.3d 1091, 1096-97 (D.C. Cir. 1998) (discussing the
16 standard necessary to reform contracts under the public interest standard in *Mobile-Sierra*
17 cases); *Atlantic City Elec. Co. v. FERC*, No. 97-1097, (D.C. Cir., July 12, 2002), at 20-21
18 (holding that generic findings of public interest were not sufficiently particularized to
19 justify reforming a contract). Specifically, the appropriate standard to evaluate whether
20 the “public interest” requires reformation of a contract should analyze and explain in
21 detail both the manner in which the contract harms the public interest and the extent to
22 which abrogation of the contract is required to mitigate the enumerated harms to that
23 public interest. *See id.*

24 The Recommended Order does not undertake such a legal or factual analysis.
25 Rather it simply posits “public interest” as an undefined standard against which the
26 Settlement is to be measured. It next proffers a series of issues or concerns which, as
discussed above, were either well known at the time the Commission approved the

1 Settlement, are already mitigated by the Settlement, can be mitigated with less onerous
2 means, or are unrelated to divestiture. Accordingly, the "public interest" justification of
3 the proposals in the Recommended Order is neither lawful nor supported by the evidence
4 of record.

5 ***D. If divestiture is stayed, APS will not be a Utility Distribution Company and***
6 ***would not be subject to any mandatory competitive bidding requirement***
7 ***under Rule 1606(B).***

8 In another inequitable and asymmetrical analysis, the Recommended Order
9 discusses at length how Rule 1615(A) regarding divestiture is linked with Rule 1606(B)'s
10 requirement for competitive bidding. Despite recognizing such linkage, the
11 Recommended Order proposes staying all of the divestiture requirements in Rule 1615(A)
12 and in the Commission-approved Settlement, but only some of the competitive bidding
13 requirements in Rule 1606(B). If APS is prohibited from divesting its generation, it will
14 not be a Utility Distribution Company and therefore will not be subject to Rule 1606(B).
15 In such a case, APS should be permitted to acquire generation from whatever means is
16 prudent and appropriate, with mandatory competitive bidding to be phased-in only as
17 divestiture is phased-in. Thus, if Rule 1615(A) is stayed in its entirety until at least July 1,
18 2004, the Recommended Order also should stay Rule 1606(B) in its entirety for an equal
19 period of time. Moreover, at a minimum, the rulemaking docket proposed at page 26 of
20 the Recommended Order should be completed before any final decision is made in Track
21 B, and the appropriate revisions needed to Rule 1606(B) should be addressed in that
22 proceeding. This would maintain the linkage between the two provisions [Rule 1615 (A)
23 and Rule 1606 (B)] that has historically existed.

24 APS has proposed amendatory language in Appendix A to address this last point.
25 If the Commission agrees with the Company's more fundamental Exception concerning
26 the sanctity of the 1999 APS Settlement, this would essentially require a complete

1 rewriting the Recommended Order. In such an eventuality, APS would suggest that the
2 ALJ be so instructed by the Commission.

3
4 **EXCEPTION NO. 3 – MARKET POWER**

5 ***A. The evidence presented during the Track A hearing demonstrates that***
6 ***APS does not have wholesale market power and that PWEC will not have***
7 ***unmitigated wholesale market power post-divestiture.***

8 APS witness Dr. William Hieronymus is probably the foremost authority on market
9 power analyses in the United States—not just as it relates to traditional utilities such as
10 APS, but regarding many of the merchant power entities as well. His analyses of market
11 power have been routinely accepted by both FERC and the United States Department of
12 Justice (“DOJ”). The market power analysis that he presented in this proceeding
13 conformed to accepted and clearly-articulated FERC and DOJ standards for such analyses.
14 Indeed, all the witnesses that even attempted to conduct a Supply Margin Assessment
15 (“SMA”) came to the conclusion that APS passes this most recent and stringent market
16 power test proposed by FERC in determining whether or not a wholesale electric market
17 is functionally competitive. (*See* Tr. vol. IV at 909-11; *see also* Rebuttal Testimony of
18 William H. Hieronymus at 1 and 5.) FERC itself has so found as to both APS and its two
19 major energy affiliates on several occasions. *See Re Arizona Public Service Company*, 79
20 FERC ¶ 61,022 (1997)⁵; *Re Pinnacle West Energy Corporation*, 92 FERC ¶ 61,2481
21 (2000); and *Re Pinnacle West Capital Corporation*, 91 FERC ¶ 61,290 (2000). It was only
22 when these other witnesses altered the fundamental assumptions of their study in order to
23 obtain a pre-ordained result, or changed the scope of their analysis to study something not
24 at issue (such as the existence of ephemeral market power in transmission constrained
25 areas of the APS service territory) that their results differed in any material way from
26 those of Dr. Hieronymus.

⁵ The Commission was a participant in this proceeding and specifically did not contest the FERC finding that APS lacked significant market power.

1 But without meaningful explanation, the Recommended Order concludes that Dr.
2 Roach's non-standard and fundamentally illogical SMA analysis should be adopted over
3 any of the accepted FERC and DOJ market power tests, all of which APS passes. Dr.
4 Roach himself did not even care if his study accurately measured wholesale market
5 power, only that the Commission find the Proposed PPA to be a bad deal for consumers.
6 (Tr. vol. III at 755.) Yet the only criticisms mentioned in the Recommended Order
7 concerning the Company's SMA analysis are those of Panda witness Roach.
8 (Recommended Order at 8.) These include (1) the inclusion in the SMA analysis of non-
9 APS transmission in determining transmission import capability; and (2) the inclusion in
10 the SMA analysis of generation not presently serving APS load. Aside from the fact that
11 both Dr. Roach and Dr. Hieronymus used the same transmission import capability, which
12 is how FERC requires the SMA test to be conducted, Staff witness Jerry Smith's own
13 recent comments at the Track B Workshop held on July 24-25 validated the use of non-
14 APS transmission resources in determining transmission import restrictions. The second
15 "criticism" is no more than a meaningless tautology. If you exclude *a priori* all the
16 possible competitors from a market power analysis, even the tiniest of suppliers will have,
17 by definition, "market power," an obviously erroneous conclusion. (See Rebuttal
18 Testimony of William H. Hieronymus at 5.)

19 The Recommended Order further states its disagreement that "must-run" protocols
20 adequately mitigate market power within certain load pockets without providing any
21 criticism of such protocols, which were developed through a stakeholder process, or
22 explaining why they are not or will not be effective. Similarly, there is no explanation
23 why prohibiting divestiture will ameliorate wholesale market power in constrained areas
24 with must-run generation when no witness at hearing suggested that non-divestiture would
25 (standing alone) provide any such amelioration. The Recommended Order further ignores
26 the mitigation afforded by must-run contracts that will be required prior to divestiture

1 under A.A.C. R14-2-1609 (I)—mitigation that was intended to address precisely this type
2 of “market power” issue identified with respect to load pockets. Thus, the market power
3 conclusions in the Recommended Order, both in general and specifically as to load pocket
4 areas, are not supported on sound public policy grounds or by the evidence of record in
5 this proceeding. The Commission should vacate such findings or, in the alternative, adopt
6 a more neutral position, as is set forth below.

7 ***B. At worst, the market power evidence in this proceeding is contradictory***
8 ***and the Commission should make no findings that APS has or does not***
have market power.

9 As discussed above APS believes that the evidence in this proceeding and the
10 application of accepted tests warrants a finding of no market power, rather than the
11 finding proposed in the Recommended Order. However, if the Commission does not
12 agree, it should simply decline to rule on this issue now and allow for the future
13 development of the more detailed market power studies suggested by Staff and included
14 in the Recommended Order (as a pre-condition to divestiture) to finally resolve this
15 question if and when such resolution becomes necessary. This would also allow time for
16 the various reforms suggested in the SMD NOPR to become effective and in any event is
17 more appropriate than adopting an unprecedented and unsanctioned market power test
18 without providing a complete explanation of why such test was adopted and why it is
19 more appropriate under the circumstances presented in this proceeding than any of the
20 accepted FERC or DOJ methods. After all, these latter agencies are, at the very least, the
21 bodies with the primary legal responsibility to identify, supervise and mitigate wholesale
22 electric market power. The Commission should be extremely hesitant to second guess
23 their findings based on, at best, conflicting evidence.

24 This is not just some abstract academic debate over whose witness was right and
25 whose was wrong. A general and affirmative Commission finding that APS does have
26 wholesale market power is a serious thing. It may produce unintended consequences and

1 have unpredictable ramifications in future FERC proceedings as well as in other contexts.
2 For example, to the extent APS continues to own generation as contemplated by the
3 Recommended Order, it is in the interest of APS retail customers that APS be able to
4 make off-system sales on as favorable of terms as possible. A Commission finding of
5 wholesale market power might be used by certain parties at FERC in an attempt to reduce
6 competition in the Arizona wholesale market by limiting the Company's pricing
7 flexibility for such off-system sales. APS has included a suggested amendment to the
8 Recommended Order in Appendix A.

9 ***C. The market power study required by the Proposed Order as a precondition***
10 ***to divestiture after July 1, 2004 is unnecessary, ambiguous, and appears to***
11 ***prejudge the results of such study.***

12 Staff witness Rowell proposes a mega-market power study encompassing
13 unspecified features of the Herfindahl-Hirschman Index ("HHI"), the "Hub and Spoke"
14 method, and the SMA market power analyses, all of which APS has already passed. Staff
15 also recommends some manner of completely undefined "strategic behavior" analysis,
16 which, as APS noted at the hearing, assumes illegal collusive behavior on the part of
17 market participants. Thus, this type of strategic behavior analysis will always conclude
18 that effective competition is impossible. This is all the more significant since market
19 power arising from assumed illegal collusion can likely never be mitigated in any
20 conventional meaning of that term, only deterred through vigorous enforcement of
21 existing antitrust laws. Because APS has passed and passes the applicable FERC and DOJ
22 market power tests, the additional market power analyses required by the Recommended
23 Order are as unnecessary as they appeared biased in favor of a predetermined outcome.
24 By purporting to adopt Staff's recommendation, the Recommended Order is also
25 impermissibly ambiguous and, because Staff advocates a strategic behavior analysis that
26 is likely impossible to overcome, appears to prejudge the outcome. At a minimum, the
Recommended Order should be amended to not expressly "adopt" Staff's

1 recommendations but to simply order APS and TEP to work with Staff to develop a
2 common approach to market power testing, monitoring, and mitigation. A suggested
3 amendment to the Recommended Order is included in Appendix A.

4 **EXCEPTION NO. 4 – CODE OF CONDUCT/AFFILIATE TRANSACTIONS**

5 *A. APS already has both a Commission-approved Code of Conduct and*
6 *FERC Standards of Conduct, in addition to this state's comprehensive set*
7 *of affiliate regulations, none of which are "broken" and in need of*
8 *"fixing" by the Recommended Order.*

9 APS presently has a Code of Conduct approved by the Commission in Decision
10 No. 62416 (April 3, 2000), as well as Policies & Procedures ("P&P") to effectuate that
11 Code. The latter were submitted and approved on June 2, 2000. The Commission has also
12 had general rules and regulations concerning affiliate transactions since the early 1990s.
13 And there have been individual Commission orders specific to APS and its affiliates. The
14 Recommended Order does not explain how or why these existing protections are
15 inadequate. Moreover, the evidence at the hearing shows that there is nothing improper
16 regarding APS' relationship with either PWM&T or PWEC that warrants additional
17 Commission action at the present time.

18 APS is also subject to FERC-imposed Standards of Conduct that prevent the
19 subsidization of generation by transmission and prevent APS from granting preferential
20 access to either its physical transmission system or to information concerning such
21 system. At present, FERC is considering significant changes to its Standards of Conduct
22 in FERC Docket No. RM01-10-000. A final order in that Docket is expected in the fourth
23 quarter of 2002. These changes may serve to moot some Code of Conduct issues raised by
24 Staff regarding the relationship of PWM&T, APS and PWEC. More significantly,
25 however, any state-mandated Code of Conduct involving wholesale affiliates must be
26 considered in the context of FERC's Standards of Conduct as they are most certainly to be
revised. Finally, if APS acquires the PWEC assets constructed or under construction to

1 serve APS load, PWEC will no longer have the ability to make significant sales of power
2 to APS.

3 Thus, if the Commission believes that a new Code of Conduct is required to
4 address the generic issues identified by Staff, it should be prepared and submitted within
5 60 days of the final decision in the FERC docket listed above to avoid unnecessary
6 conflict with FERC's final resolution on wholesale Standards of Conduct. It should also
7 take into consideration the then-existing status of PWEC as a potential seller in the
8 Arizona wholesale market. As APS has previously noted, the rate protections in the
9 Settlement provide ample time to accommodate this request without jeopardizing
10 consumer protection. Suggested language is provided in Appendix A.

11
12 **EXCEPTION NO. 5 – THE RECOMMENDED ORDER'S TREATMENT OF**
TRANSMISSION CONSTRAINTS IS CONFUSING AND PREMATURE

13 The Recommended Order indicates that it is in general agreement with Staff's
14 recommendations on transmission issues. It further directs APS and TEP to develop a plan
15 regarding RMR generation concerns in the next Biennial Transmission Assessment. While
16 the Track A hearings indicated more agreement between Staff and APS than might have
17 been apparently from simply reading pre-filed testimony, the Recommended Order does
18 not appropriately address transmission issues, does not consider or articulate the evidence
19 regarding transmission issues, and, like other portions of the Recommended Order,
20 asymmetrically imposes unreasonably vague obligations on APS and TEP, but not on
21 other parties.

22 Specifically, the significance of Recommended Order's acknowledgement that it is
23 in "general" agreement with Staff's recommendations is unclear, particularly given that
24 much of Staff's recommendations depend on additional study work and the completion of
25 the next Biennial Transmission Assessment. Thus, the Recommended Order should be
26 clear that it does not in itself adopt any particular recommendations of Staff apart from

1 those specifically identified in the ordering paragraphs. For example, if Staff wishes to
2 impose its non-industry standard reliability requirements on jurisdictional parties, the
3 appropriate place and method is in the further rulemaking proceedings contemplated in the
4 Recommended Order or a rulemaking proceeding following the Biennial Transmission
5 Assessment. Either forum should explicitly consider the sort of cost/benefit analysis
6 discussed by both Staff witness Smith and Company witness Deise in addition to the
7 potentially significant impact on native load customers of jurisdictional transmission-
8 owning utilities such as APS and TEP.

9 None of the RMR and transmission issues discussed in the Track A hearing were
10 noticed as Track A issues in the Commission's Procedural Order of May 2, 2002, and all
11 are ultimately unrelated to Track A or are otherwise addressed in different sections of the
12 Recommended Order (i.e., localized market power). Because the Commission's Biennial
13 Transmission Assessment is underway, the most appropriate way of addressing
14 transmission issues is simply to defer to such Assessment or to the follow-on rulemakings
15 contemplated in the Recommended Order. Including vague and unspecified findings and
16 discussion on transmission issues in the Track A order risks confusing the issues and
17 interfering with other pending or contemplated Commission proceedings. Specific
18 amendatory language is provided in Appendix A.

19
20 **EXCEPTION NO. 6 – THE RECOMMENDED ORDER'S DISCUSSION OF**
CERTAIN "JURISDICTIONAL ISSUES" IS INCOMPLETE

21 The Recommended Order concludes at page 25—with no discussion or legal
22 analysis—that “[All] [t]he parties are in agreement that once as asset transfer occurs,
23 APS' acquisition of power would be wholesale transactions under the jurisdiction of
24 FERC and that FERC has jurisdiction over both profit and not-for-profit RTOs.” First,
25 APS does not agree that this is a jurisdictional issue created solely by divestiture. FERC
26 has had and will continue to have jurisdiction over most wholesale sales to APS and TEP

1 irrespective of any divestiture. Other wholesale transactions, such as the SRP sale to APS,
2 are not regulated by either FERC or the Commission—a circumstance also unrelated to
3 divestiture. Second, this conclusion accurately states the “form” but ignores the more
4 important “substance” on the jurisdictional issue that was discussed in APS’ Brief. Most
5 of the Commission’s historical oversight of the state-regulated operations of APS,
6 including the determination of the prudence of resource acquisition, the deployment and
7 use of resources, and when resources are “used and useful” will remain unaffected by
8 divestiture. The Proposed PPA, because it involved an affiliate of APS, would have
9 further preserved and complemented the historical oversight jurisdiction of the
10 Commission as to APS. Thus, the Commission’s “loss” of jurisdiction is more apparent
11 than real, a fact which should be acknowledged in the Recommended Order.

12 On the RTO issue, the Recommended Order is certainly correct in so far as it goes.
13 But APS believes that the jurisdictional issue posed by Chairman Mundell during the
14 course of the Track A hearing had somewhat less to do with FERC’s jurisdiction than the
15 Commission’s. Thus, the Recommended Order should also find that the Commission’s
16 own jurisdiction is unaffected by whether an RTO is for-profit or not-for-profit. The
17 Company has provided amendatory language for this section of the Recommended Order
18 in Appendix A.

19
20 **EXCEPTION NO. 7 – A.R.S. § 40-252 REQUIRES**
SPECIFIC NOTICE TO APS AND HEARING “AS UPON COMPLAINT”

21 These proceedings do not and have not complied with the procedural requirements
22 of A.R.S. § 40-252. Such a proceeding requires that the Commission give affected parties
23 specific notice of both the Commission orders or portions of orders that are being
24 considered for amendment or rescission and, in the case of the former, the specific
25 amendments that are to be considered in such proceeding. The very fact that the parties
26 were requested to identify in their post-hearing briefs the orders that will have to be

1 rescinded or amended is conclusive proof that the initial notice to the Company in this
2 generic proceeding was legally inadequate to comply with A.R.S. § 40-252.

3 Also, the evidentiary hearing required under A.R.S. § 40-252 must be “as upon
4 complaint.” Although the literal requirements for a “complaint” are generally discussed in
5 A.R.S. § 40-246, more fundamentally, a complaint is an adversarial process requiring that
6 the accusing party, in this case the Commission (through Staff) first present its evidence
7 before requiring the defending party, in this case APS, to respond. It is a process that is
8 inherently inconsistent with an investigative “generic proceeding,” where the focus is on
9 general policies rather than the specific adjudicative facts, if any, warranting a change to
10 or rescission of a prior Commission decision.

11 If the Commission will also recall, at the Special Open Meeting of July 12, 2002
12 held to consider TEP’s own requested variance, several non-APS parties spoke. At least
13 two indicated that they believed a further and separate evidentiary hearing would be
14 required prior to any amendment of the Commission decisions approving the TEP and
15 APS Settlements. The failure by the Commission to afford a party procedural rights
16 provided by statute is per se reversible error. *Southern Pacific Co. v. Corporation*
17 *Commission*, 83 Ariz. 333 (1958). Thus, the Commission should accept the Company’s
18 arguments on this important point of law and procedure.

19
20 **CONCLUSION**

21 The Settlement has been a good deal for APS customers and for Arizona. It has
22 saved consumers hundreds of millions of dollars, insulated them from some of the most
23 turbulent energy markets ever experienced, promoted regional transmission planning, and
24 provided the promise of retail competition—a promise no less valuable simply because it
25 has yet to be realized. The Recommended Order acknowledges as much by the fact that it
26 has suggested changes to only one part of that Settlement. But such selective and one-

1 sided contract “reformation” is neither lawful nor, in the words of the Recommended
2 Order, “fair.” It leaves the PWEC Reliability Assets bifurcated from the balance of the
3 Company’s generation, something never contemplated by the Electric Competition Rules
4 or the Settlement. It effectively punishes the Company for its successful efforts to meet
5 the fast-growing needs of its customers during the period after the Settlement but before
6 the divestiture and competitive procurement envisioned by those same Rules were
7 implemented. It is also unnecessary given the Company’s willingness to devote all of its
8 generating assets, as well as the PWEC Reliability Assets constructed in its behalf, to APS
9 customers at essentially cost-of-service, i.e., regulated prices, either through the Proposed
10 PPA or the alternative of allowing APS acquisition of those same PWEC Reliability
11 Assets.

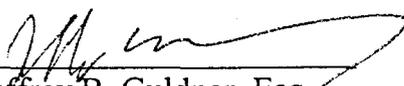
12 As noted above, and in addition to the Proposed PPA, the Company has provided a
13 viable and practical alternative short of divestiture by year-end 2002—one that both
14 addresses the “bifurcation issue” (and the critical financial dilemma that continued
15 “bifurcation” presents) and preserves the Commission’s flexibility to reconsider both
16 divestiture and increased reliance on the competitive wholesale market after July 1, 2004.
17 As set forth most recently in the Company’s July 11th letter, this requires the acquisition
18 by APS of the PWEC Dedicated Assets subject to whatever additional formal financing
19 approvals are required. The Commission’s determination of all rate-making issues such as
20 prudence and “used and useful” would be deferred for a later and more appropriate forum.

21 The inclusion by the Commission in any final order on Track A of specific
22 language endorsing this compromise solution would constitute a critical first step to a
23 “fair” and balanced reformation of the original Settlement in a manner the Company could
24 affirmatively embrace rather than be forced to litigate. Moreover, other provisions of the
25 APS Settlement that are thus affected by the Commission’s determination herein should
26 be subject to further reconsideration by the Commission during the Company’s next rate

1 proceeding or, at the discretion of the Commission, in a separate proceeding held prior to
2 the next rate case.

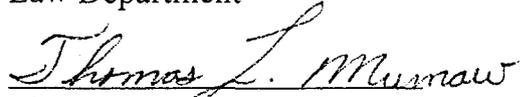
3 RESPECTFULLY SUBMITTED this 1st day of August 2002.

4 SNELL & WILMER L.L.P.

5 
6 Jeffrey B. Guldner, Esq.
7 Faraz Sanei, Esq.

8 and

9 PINNACLE WEST CAPITAL CORP.
10 Law Department

11 
12 Thomas L. Mumaw, Esq.

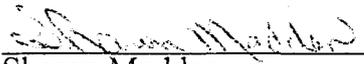
13 Attorneys for Arizona Public Service Company

14
15
16 Original and 18 copies of the foregoing
17 filed this 1st day of August 2002, with:

18 Docket Control
19 Arizona Corporation Commission
1200 West Washington
Phoenix, AZ 85007

20 Copies of the foregoing mailed, faxed or
21 transmitted electronically this 1st day of
22 August 2002, to:

23 All parties of record

24 
25 Sharon Madden

26 1218369.1

APPENDIX A

**ARIZONA PUBLIC SERVICE COMPANY'S
PROPOSED AMENDMENT #1
(Exception No. 1)**

Page 24, line 4

INSERT - "While we conclude that the public interest requires us to stay the divestiture requirement found in R14-2-1615(A) and approved as to APS in Decision No. 61973, we believe that our decision must be fair to all parties, including APS and its affiliates who have performed their obligations under the settlement agreement approved in Decision No. 61973. Accordingly, we support APS in acquiring and obtain financing for Redhawk Units 1 and 2, West Phoenix Units 4 and 5, and Saguaro Unit 3, which were or are being constructed by APS' affiliate, Pinnacle West Energy Corporation. We do so without prejudice to our traditional rate-making determinations in a future proceeding of whether such acquisition was prudent on the part of APS or whether the capacity and energy so obtained was "used and useful" in the provision of electric service by APS to its retail customers—issues common to all APS-owned assets.

DELETE paragraph starting at line 4 to line 12.

DELETE paragraph starting at line 13 to line 18.

Page 25, line 23

DELETE paragraph starting on line 23 to line 26 ½.

Page 30, line 12

DELETE Finding of Fact No. 43.

INSERT new Finding of Fact No. 43 - "APS may acquire Redhawk Units 1 and 2, West Phoenix CC Units 4 and 5, and Saguaro CT Unit No. 3 and associated property at its discretion and may secure financing for such units up to the limits heretofore established by the Commission, with any additional financing authority to be requested by APS in a separate proceeding in accordance with the provisions of A.R.S. § 40-301, *et seq.*"

RENUMBER other Findings of Fact accordingly.

**ARIZONA PUBLIC SERVICE COMPANY'S
PROPOSED AMENDMENT #2
(Exception No. 2)**

Page 23, line 13

INSERT at conclusion of paragraph - "Because R14-2-1615(A) and R14-2-1606(B) have always been paired together and have historically been treated the same, we will likewise stay R14-2-1606(B) until at least July 1, 2004 and also until the asset transfers discussed above are implemented."

DELETE paragraph beginning on line 13 ½ to line 21 ½.

Page 29, line 15 ½

DELETE Finding of Fact No. 36.

INSERT new Finding of Fact No. 36 - "A.A.C. R14-2-1606(B) should be stayed and any portions of Decision Nos. 61973 and 62103 which refer to A.A.C. R14-2-1606(B) should be modified to stay the requirement that 100 percent of power purchased for Standard Offer Service shall be acquired from the competitive market, with at least 50 percent through a competitive bid process until at least July 1, 2004 and until the asset transfers discussed in Finding of Fact No. 35 are implemented."

Page 29, line 21 ½

DELETE Finding of Fact No. 37.

RENUMBER Findings of Fact accordingly.

Page 31, line 25 ½

INSERT after "...competitive bid process" the words "until at least July 1, 2004 and until the asset transfers are implemented."

DELETE ordering paragraph beginning on line 26 ½ and ending on page 32, line 2 ½.

Page 32, line 3

DELETE ordering paragraph beginning on line 3 and ending on line 6 ½.

**ARIZONA PUBLIC SERVICE COMPANY'S
PROPOSED AMENDMENT #3
(Exception No. 3)**

Page 21, line 17 to line 21½

DELETE sentence (beginning on page 21, line 17 through sentence ending on page 21, line 21 ½).

INSERT - "We believe that the evidence on market power is contradictory, and we will decline to make a specific market power finding at this time pending submission of the additional market power analyses suggested herein."

Page 28

DELETE Findings of Fact Nos. 17 through 21.

INSERT new Finding of Fact No. 17 - "We believe the evidence on market power is contradictory, and we will decline to make a specific market power finding at this time."

RENUMBER Findings of Fact accordingly.

**ARIZONA PUBLIC SERVICE COMPANY'S
PROPOSED AMENDMENT #4
(Exception No. 3)**

Page 21, lines 25-26

DELETE - "Accordingly, we adopt Staff's recommendations and"

INSERT - "We"

Page 21, line 27

DELETE - "with AECC and RUCO that the parties"

INSERT - "that APS and TEP"

Page 21, line 28

DELETE - "seek a consensus"

INSERT - "work with Staff to develop a common"

**ARIZONA PUBLIC SERVICE COMPANY'S
PROPOSED AMENDMENT #5
(Exception No. 4)**

Page 32, line 18

DELETE - "within 60 days of the effective date of this Decision".

INSERT - "within 60 days of a final decision by FERC on Standards of Conduct in FERC Docket No. RM01-10-000, but no later than January 1, 2003".

**ARIZONA PUBLIC SERVICE COMPANY'S
PROPOSED AMENDMENT #6
(Exception No. 5)**

Page 25, line 14 ½

DELETE paragraph starting on line 14 ½ to line 22 ½.

INSERT new paragraph at line 14 ½ - "We agree that transmission issues are important in transitioning to a competitive marketplace and we encourage an industry-wide planning process to address transmission constraints. However, transmission issues, including studies relating to RMR generation, should be addressed in our Biennial Transmission Assessment or in a subsequent rule making or similar docket as opposed to this proceeding. These issues should be considered in the light of their potential impact on native load customers and after rigorous cost/benefit analysis."

Page 30, line 1 ½

DELETE Finding of Fact No. 39.

INSERT new Finding of Fact No. 39 - "Transmission issues, including studies relating to RMR generation, should be addressed in our Biennial Transmission Assessment or in a subsequent rule making or similar docket as opposed to this proceeding. These issues should be considered in the light of their potential impact on native load customers and after rigorous cost/benefit analysis."

DELETE Finding of Fact No. 40.

DELETE Finding of Fact No. 41.

RENUMBER Findings of Fact accordingly.

Page 32, line 10

DELETE ordering paragraph beginning at line 10 to line 12.

DELETE ordering paragraph beginning at line 13 to line 14 ½.

**ARIZONA PUBLIC SERVICE COMPANY'S
PROPOSED AMENDMENT #7
(Exception No. 6)**

Page 25, line 7 ½

DELETE - paragraph beginning at line 7 ½ to line 9 ½.

INSERT - "While FERC will continue to have jurisdiction over wholesale power sales after the assets transfer occurs, the Commission will still have significant jurisdiction over the service by electric public service corporations to retail customers. Further, the Commission's jurisdiction over such public service corporations is unaffected whether an RTO approved by FERC is for-profit or not-for-profit."

Page 30, line 20 ½

INSERT new Finding of Fact No. 46 - "The parties agree that the Commission's jurisdiction over public service corporations is unaffected whether an RTO approved by FERC is for-profit or not-for-profit."

Page 31, line 19

INSERT new Conclusion of Law No. 11 - "The Commission's jurisdiction over public service corporations is unaffected by whether such public service corporations participate in a for-profit or not-for-profit RTO."

