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BEFORE THE ARIZONA CORPORATION COMMISSION **RECEIVED**

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WILLIAM A. MUNDELL  
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Arizona Corporation Commission

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AZ CORP COMMISSION  
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IN THE MATTER OF ARIZONA PUBLIC  
SERVICE COMPANY'S REQUEST FOR A  
VARIANCE OF CERTAIN REQUIREMENTS OF  
A.A.C. R14-2-1606

Docket No. E-01345A-01-0822

STAFF'S RESPONSE

INTRODUCTION

On October 18, 2001, Arizona Public Service Company ("APS" or "Company") submitted a document titled "Request of Arizona Public Service Company for a Partial Variance to A.A.C. R14-2-1606(B) and for Approval of a Purchase Power Agreement" (the "APS Request"). On its face, the document appears to state a relatively simple and narrow request, which APS requests that the Arizona Corporation Commission ("Commission") act on by the end of calendar year 2001. Specifically, APS asks the Commission to grant a partial variance to the requirements of A.A.C. R14-2-1606, and approve a long term power agreement between APS and its parent, Pinnacle West Capital Corporation ("PWCC"). In its application, APS asserts that the actions requested from the Commission are necessary to allow it to provide reliable electric service for Standard Offer customers, at reasonable rates.

Staff has commenced consideration of the APS Request, and submits this Response as our first step in devising a procedure to ensure adequate, thoughtful and fair consideration of the request. As will become clear during the course of this Response, it is Staff's opinion that the APS Request has far-reaching implications in connection with the Commission's attempts to restructure the electric utility industry in Arizona. This Response will not attempt to identify each and every issue raised by the APS Request. Rather, we will identify the major issues and propose a procedural process to facilitate the Commission's thoughtful consideration of the Rules and Settlements implicated thereby.

1 **I. THE COMMISSION SHOULD ISSUE ORDERS PRESERVING THE PRE-**  
2 **RESTRUCTURING CORPORATE STRUCTURES PENDING REVIEW**

3 The APS Request contemplates APS entering into the PPA with its affiliate PWCC before the  
4 end of 2001. As we will explain in more detail later in this Response, Staff does not believe that APS  
5 has adequately supported its Request, either by factual support or by analysis. Nevertheless, the APS  
6 Request does raise serious issues about the nature of the market restructuring contemplated under the  
7 Electric Competition Rules and the Settlement Agreements. It is clear that circumstances have  
8 materially changed since the Commission adopted the Electric Competition Rules and the Settlement  
9 Agreements. In conjunction with the ongoing litigation involving both the Rules and the APS  
10 Settlement, Staff believes that it is wise to commence a proceeding to review the circumstances  
11 which led to the APS Request.

12 Because it contemplates entry into the PPA before the end of 2001, the APS Request is  
13 plainly predicated on APS transferring its generation assets, with the exception of Palo Verde Nuclear  
14 Generating Station to PWCC before the end of the year. The transfer of assets would create an  
15 irrevocable change in the jurisdiction which sets rates for the generation. While APS has sought  
16 Commission approval of the PPA, if the transaction is a true wholesale power supply agreement, rates  
17 would be subject to the jurisdiction of the FERC. Furthermore, as was discovered in California, once  
18 the assets have been transferred, this Commission would not have authority to require their return to  
19 APS. The analysis of the reasonableness of the PPA may yield very different results if it takes place  
20 in an environment where the generation assets are no longer under this Commission's jurisdiction.

21 Thus, while Staff has not reached any ultimate conclusion regarding what changes to the  
22 Electric Competition Rules might be appropriate, or what the ultimate disposition of the APS Request  
23 should be, we have reached a conclusion about the environment in which the analysis should be  
24 conducted. Staff believes that APS should be directed to retain ownership of its generation assets,  
25 pending completion of the Commission's review in this docket. This direction is not inconsistent  
26 with the APS Settlement Agreement, as approved by the Commission. Under Section 4.1(1) of the  
27 Addendum to the Settlement Agreement, APS is not required to complete the divestiture of  
28 generation assets before December 31, 2002. Staff strongly believes that retention of the assets is an

1 essential element to the conduct of a fair review of the APS Request, which Request is inconsistent  
2 with the Settlement Agreement. It should be noted that under the Settlement Agreement APS already  
3 has until December 31, 2002 to comply with A.A.C. R14-2-1606(B), as well as to complete the  
4 transfer of its generation assets. Staff's Request does not foreclose the meeting of those  
5 requirements.

6  
7 **II. THE APS REQUEST IS INCONSISTENT WITH THE CURRENT ELECTRIC  
8 COMPETITION RULES AND SETTLEMENTS**

9 The APS Request indicates that the Company has reached the "inescapable conclusion that  
10 adherence to the competitive bidding requirements of the Electric Competition Rules will not produce  
11 the intended result of reliable retail electric service for Standard offer customers at reasonable rates".  
12 In response to this "inescapable conclusion" APS proposes that the Commission grant it a variance to  
13 A.A.C. R14-2-1606(B), and approve the proposed Purchase Power Agreement between APS and  
14 PWCC (the agreement is hereinafter referred to as the "PPA"). The inference to be drawn from the  
15 way APS formulates the issue is that approval of its request will produce what it has described as the  
16 intended result of the Electric Competition Rules, i.e. reliable retail electric service for Standard Offer  
17 customers at reasonable rates.

18 Staff is not inclined to quibble with APS over whether it has correctly stated the one objective  
19 of the Electric Competition Rules that it mentions. However, it is clear to Staff that the Electric  
20 Competition Rules and the associated Settlement Agreements, including the Settlement Agreement  
21 with APS, as approved in Commission Decision Nos. 61973 and 62035, have much broader  
22 objectives than just preserving reliable electric service for Standard Offer customers at reasonable  
23 rates. APS Standard Offer customers had reliable service at reasonable rates before the Commission  
24 commenced its restructuring efforts. Certainly the Electric Competition Rules and Settlements had  
25 broader objectives than the one identified by APS. It has been clear from the outset that the  
26 Commission's efforts in adopting the Electric Competition Rules and the Settlement Agreements  
27 under those Rules has been to completely restructure the electric industry to one in which electric  
28 generation was a fully competitive service.

1 A fully competitive electric generation market under the Commission's Rules and approved  
2 Settlement Agreements includes several requirements. Customers must have access to competitive  
3 generation service. Under A.A.C. R14-2-1604(D), the Rules contemplated that all customers would  
4 have access to competitive electric services by January 1, 2001. Access to competitive services  
5 implies the ability to actually acquire such services. In furtherance of that objective, A.A.C. R14-2-  
6 1609 anticipates the establishment of an Arizona Independent Scheduling Administrator ("AISA"), as  
7 well as either a regional Independent System Operator ("ISO") or a Regional Transmission  
8 Organization ("RTO"). In addition, in order for customers to have access to competitive services,  
9 A.A.C. R14-2-1615 provided for separation of competitive services from monopoly services, with the  
10 clear objective of enhancing the development of a competitive market in certain services while  
11 retaining traditional regulatory authority over services supplied by the monopoly provider or Utility  
12 Distribution Company ("UDC").

13 The competitive bidding requirement of A.A.C. R14-2-1606(B) is an integral part of the  
14 development of the restructured electric generation market. The Rules envisioned that a significant  
15 portion of the electric generation would be supplied by a UDC, such as a post-divestiture APS, and  
16 would be available for competitive bid, thereby facilitating the establishment of competitive  
17 generators. The transactions are required to be arms-length, thereby furthering the separation of the  
18 UDC from any affiliated competitive generation supplier. And, in conjunction with the required open  
19 access transmission system, supported by an AISA, an ISO or an RTO, a competitive electric services  
20 market is established.

21 The APS Request is in contravention of every objective of the Commission's Electric  
22 Competition Rules, as well as the APS Settlement. The APS Request contains the conclusory  
23 statement that it seeks no change in the current ability of APS' customers to choose competitive  
24 suppliers of electric generation service, while at the same time proposing relief that may lock  
25 competitors out of the market for years to come. Furthermore, the Commission is well aware of the  
26 status of the AISA and the APS Request itself explains that the currently planned transmission entity  
27 is "WestConnect", which is certainly not the Desert Star ISO contemplated by Section 7.6 of the APS  
28 Settlement Agreement. There is no reason to believe that APS customers will actually be able to

1 receive competitive electric services if the APS Request is granted, notwithstanding the requirements  
2 in both the Electric Competition Rules and the APS Settlement. Nor would the approval of the APS  
3 Request have the effect of separating the monopoly service provider from the provider of competitive  
4 generation services. In fact, the PPA is styled as a full requirements contract between APS and  
5 PWCC. While such a contract adjusts the ownership of the electric generation assets, it ensures that  
6 Standard Offer customers receive non-competitive generation service. Having the single largest  
7 customer base in Arizona served by non-competitive, affiliated generation, on a full requirements  
8 basis, does not sound like a prescription for the development of competitive generation in Arizona.  
9 And, of course, the term of the PPA would ensure that no competitive electric generation market  
10 could develop in Arizona for the next 15 years. In addition, while the APS Request would only have  
11 direct impact in the APS service territory, removing the APS Standard Offer customer base as a  
12 potential market for competitive electric generation would probably act to stifle any possibility of a  
13 competitive electric generation market developing anywhere in the state, including within TEP's  
14 service area.

### 15 **III. APS HAS NOT PROVIDED ANY SUPPORT FOR ITS REQUEST**

16 The APS Request is rife with unsupported factual assertions, as well as implying specific  
17 policy positions without giving the Commission full basis upon which to consider them. For  
18 example, APS offers no study or analysis to demonstrate that it would be unable to successfully  
19 comply with Rule 1606(B). On page 3, APS asserts that it is impractical to bid-out some 3000 Mw  
20 of system load, asserting its view that few, if any, non-affiliated generators would be able to supply  
21 such a large block of power. APS makes its assertion without even mentioning the significant  
22 amount of generation that has been approved for siting throughout the state in the recent past.  
23 Bearing in mind that, if the Rules were implemented, an APS affiliate would be in a position to  
24 participate in an arms-length bidding process, and that the bidding process would likely encompass a  
25 number of smaller increments adding to the 3000 Mw, rather than a single lump-sum bid, Staff is  
26 unable to conclude that APS is correct.

27 APS asserts that the Commission should be concerned about the over-reliance on volatile  
28 natural gas supplies. However, APS' own affiliate Pinnacle West Energy Corporation ("PWEC")

1 may be susceptible to the same claims. Nor does APS explain how signing the PPA would act to  
2 prohibit PWCC from overemphasizing natural gas in complying therewith.

3 APS expresses concern about the mechanisms available to ensure that electric generation  
4 contracted for under a bidding procedure would actually become available to provide service,  
5 explaining its view that only APS has the “provider of last resort” obligation relating to its Standard  
6 Offer customers. However, APS offers no adequate explanation, nor testimony to support the notion  
7 that only PWCC can be committed to become a “wholesale provider of last resort”. APS would also  
8 ask the Commission to assume that the PPA provides a superior mechanism to assure the actual  
9 provision of power than any contract which might be entered with any other entity. Nor does APS  
10 provide any explanation or support for its assertion that only itself or PWCC can provide power with  
11 adequate reliability to support the APS Standard Offer customers.

12 Finally, APS contends that the prices under the PPA would be just and reasonable. APS  
13 provides no analytical support for the notion. The APS Request is devoid of analysis of either the  
14 PPA or any alternative means to provide electric generation service to APS Standard Offer  
15 customers. The APS Request does not even provide any comparison of prices under the PPA to  
16 current market prices.

17  
18 **IV. THE COMMISSION SHOULD COMMENCE A PROCEEDING TO REVIEW THE  
CIRCUMSTANCES WHICH LED APS TO FILE ITS REQUEST**

19 Staff does not support the notion of simply denying the APS Request. The request is clearly  
20 inconsistent with the Commission’s Electric Competition Rules, and the APS Settlement.  
21 Nevertheless, it is also true that circumstances have changed since the Commission last considered  
22 the Electric Competition Rules. The APS Request also points out clearly that circumstances have  
23 changed since the Commission approved the APS Settlement. While the APS Request does not state  
24 a request to amend the Settlement, it is clear that to grant the Request would necessitate doing so.  
25 The request for a waiver of A.A.C. R14-2-1606(B) necessarily acknowledges that APS would be  
26 required to comply with its provisions if the Settlement Agreement is to be enforced as written.  
27 Compliance with A.A.C. R14-2-1606(B) was specifically required under Section 4.1(3) of the  
28 Addendum to the Settlement Agreement. In addition, it is equally clear that the formation of

1 WestConnect and the associated termination of actions in support of the Desert Star ISO require  
2 amendment to the Settlement Agreement.

3 It is also true that the APS Settlement indicated that one of its benefits would be to avoid  
4 substantial litigation and associated costs. We can now see that, notwithstanding the APS Settlement,  
5 substantial litigation and associated costs, as well as associated risks, have ensued. The APS  
6 Settlement itself continues to be the subject of litigation. In addition, the Electric Competition Rules  
7 continue to be the subject of litigation, raising questions which include the viability of the regulatory  
8 structure contemplated at the time the APS Settlement was negotiated and approved.

9 As indicated above, Staff does not advocate simple denial of the APS Request. Rather, Staff  
10 believes that the Commission should take this opportunity to recognize that conditions have changed  
11 since the adoption of the Electric Competition Rules and the APS Settlement. APS plainly believes  
12 that circumstances have changed since the Commission approved the Electric Competition Rules and  
13 its Settlement Agreement. APS has proposed one possible manner of addressing the changing  
14 circumstances in its Request. Whether the other signatories to the APS Settlement Agreement, or  
15 other members of the public, will view the situation in the same manner is an open question. APS  
16 gives no indication of having discussed these matters with the other signatories, or of having  
17 convened a conference under Section 7.8 of the Settlement Agreement for purposes of resolving any  
18 potentially conflicting opinions as to the interpretation of the Agreement.

19 Staff believes that the present time is an appropriate one for the Commission to reexamine the  
20 circumstances surrounding the Electric Competition Rules and the Settlements approved thereunder.  
21 The APS Request demonstrates that there is serious question as to whether the existing Rules and  
22 Settlements will result in a market restructuring as contemplated when approved. Furthermore, if the  
23 Commission approves amendments to the APS Settlement and/or waiver to the competitive bidding  
24 requirements of A.A.C. R14-2-1606(B), such changes are likely to have sufficient impact on  
25 Arizona's overall market restructuring effort to constitute an emergency situation requiring  
26 reexamination of the Tucson Electric Power Company ("TEP") Settlement Agreement. The TEP  
27 Settlement contains similar provisions to the APS Settlement. While TEP has not sought amendment  
28 to its Settlement as APS has, the abandonment of Desert Star and the Commission's considered

1 treatment of the AISA, as well as the implications of the APS Request across the broader market, all  
2 support the notion of reexamining the market restructuring effort. Staff believes the proceeding  
3 commenced in response to the APS Request should include the continued viability of the TEP  
4 Settlement. The Commission should also direct that TEP refrain from divesting its generation assets  
5 while the proceeding takes place.

#### 6 **V. PROPOSED PROCEDURAL SCHEDULE**

7 The APS Request would require the Commission to act before the end of 2001. In light of  
8 the magnitude of the issues and the lack of factual or analytical support for the APS Request, Staff  
9 cannot support a procedural schedule that would result in a Commission Order before year's end. In  
10 fact, since the nature and breadth of the issues to be addressed has not yet been determined, Staff  
11 would suggest that a partial procedural schedule be established at this time, leading up to a procedural  
12 conference to establish final dates for Commission consideration of the matter.

13 Specifically, Staff would request that APS be required to submit testimony and analytical  
14 support for its Request on or before December 7, 2001. Following a brief period for the parties to  
15 review the testimony and analysis, a Procedural Conference could be held on or about December 14,  
16 2001 to establish subsequent testimony filing dates and a date for an evidentiary hearing.

#### 17 **VI. CONCLUSION**

18 Significant events have occurred since the last time the Commission had occasion to consider  
19 its Electric Competition Rules and the Settlement Agreements approved under those Rules. The APS  
20 Request is an indication that one of the most significant participants in a restructured electricity  
21 market in Arizona believes that fundamental aspects of the restructuring should be reconsidered and  
22 changed dramatically. The changes proposed by APS are not just dramatic, but of a lengthy duration.

23 While Staff cannot agree with the APS Request at this time, we do support a careful  
24 examination of the facts and analysis which have led APS to submit its Request. We will then  
25 support any changes to the Electric Competition Rules and Settlement Agreements that are justified  
26 by the record. Staff anticipates substantial participation from potentially affected entities and  
27 believes that this proceeding should be conducted in a thorough, well considered manner. Staff's  
28 proposed procedural approach is intended to provide the parties with an opportunity to provide a

1 detailed record and the Commission with an adequate opportunity to address the APS Request after  
2 fully considering its implications for electric restructuring in Arizona.

3 RESPECTFULLY SUBMITTED this 16th day of November, 2001.

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5  
6 Christopher C. Kempley

7 Christopher C. Kempley  
8 Chief Counsel  
9 Arizona Corporation Commission  
10 1200 West Washington  
11 Phoenix, Arizona 85007  
12 (602) 542-3402

13 Original and ten copies of the foregoing  
14 filed this 16th day of November, 2001,  
15 with:

16  
17 Docket Control  
18 Arizona Corporation Commission  
19 1200 West Washington  
20 Phoenix, AZ 85007

21 Copy of the foregoing mailed this 16th  
22 day of November, 2001, to:

23  
24 Thomas L. Mumaw  
25 Jeffrey B. Guldner  
26 Snell & Wilmer, LLP  
27 One Arizona Center  
28 Phoenix, AZ 85004-2202  
Attorneys for Arizona Public  
Service Company

Nancy Roe