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BEFORE THE ARIZONA CORPORATION



WILLIAM A. MUNDELL  
CHAIRMAN  
JIM IRVIN  
COMMISSIONER  
MARC SPITZER  
COMMISSIONER

IN THE MATTER OF ARIZONA PUBLIC SERVICE ) COMPANY'S REQUEST FOR A VARIANCE OF ) <u>CERTAIN REQUIREMENTS OF A.A.C. R14-2-1606</u> )	DOCKET NO. ██████████
IN THE MATTER OF THE GENERIC PROCEEDINGS ) <u>CONCERNING ELECTRIC RESTRUCTURING.</u> )	DOCKET NO. E-00000A-02-0051
IN THE MATTER OF TUCSON ELECTRIC POWER ) COMPANY'S APPLICATION FOR A VARIANCE OF ) CERTAIN ELECTRIC COMPETITION RULES ) <u>COMPLIANCE DATES.</u> )	DOCKET NO. E-01933A-02-0069
IN THE MATTER OF THE APPLICATION OF ) TUCSON ELECTRIC POWER COMPANY FOR ) <u>APPROVAL OF ITS STRANDED COST RECOVERY.</u> )	DOCKET NO. E-01933A-98-0471
IN THE MATTER OF THE GENERIC PROCEEDING ) CONCERNING THE ARIZONA INDEPENDENT ) <u>SCHEDULING ADMINISTRATOR</u> )	DOCKET NO. E-00000A-01-0630

NOTICE OF FILING

The Arizona Utility Investors Association hereby provides notice of filing Responsive Testimony by Walter W. Meek as provided by the Commission's procedural order in the above-captioned matter, dated May 3, 2002..

DATED THIS 11TH DAY OF JUNE, 2002.

*Walter W. Meek*  


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WALTER W. MEEK, PRESIDENT

CERTIFICATE OF SERVICE

Original and eighteen (18) copies of the referenced Testimony were filed this 11th day of June, 2002, with:

Docket Control  
Arizona Corporation Commission  
1200 W. Washington Street  
Phoenix, AZ 85007

Copies of the referenced Testimony were hand-delivered this 11th day of June, 2002, to:

Arizona Corporation Commission  
**DOCKETED**

JUN 11 2002

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Copies of the referenced Testimony  
Were faxed or mailed this 11<sup>th</sup> day of  
June, 2002, to:

Appropriate parties of record

1 RESPONSIVE TESTIMONY OF WALTER W. MEEK

2 ON BEHALF OF THE

3 ARIZONA UTILITY INVESTORS ASSOCIATION

4  
5 Docket No.. E-00000A-02-0051, et al.  
6  
7  
8  
9

10 PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

11 My name is Walter W. Meek. My business address is 2100 North Central Avenue, Suite  
12 210, Phoenix, Arizona 85004.

13  
14 BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

15 I am the president of the Arizona Utility Investors Association ("AUIA" or  
16 "Association"), a non-profit organization formed to represent the interests of  
17 shareholders and bondholders who are invested in utility companies that are based in  
18 or do business in the state of Arizona.

19  
20 ARE SOME AUIA MEMBERS SHAREHOLDERS OF PINNACLE WEST CAPITAL  
21 CORPORATION?

22 Yes. AUIA has approximately 6,000 members and a substantial percentage are  
23 common shareholders of Pinnacle West Capital Corporation ("PWCC"), the corporate  
24 parent of Arizona Public Service Company ("APS"). Our members also include  
25 shareholders of UniSource Energy Corporation, the parent of Tucson Electric Power  
26 Company ("TEP").  
27

28 WHAT IS YOUR BACKGROUND IN REPRESENTING SHAREHOLDER CONCERNS  
29 AND INTERESTS?

30 I have been president of AUIA for more than eight years. Prior to that, my consulting  
31 firm managed the affairs of the Pinnacle West Shareholders Association for 13 years.  
32 During this time we have represented shareholders in numerous rate cases and other  
33 regulatory matters and have published many position papers, newsletters and other  
34 documents in support of shareholder interests.  
35

1 WHAT IS THE PURPOSE OF YOUR TESTIMONY?

2 I am here to represent the views of the equity owners of PWCC and UniSource  
3 regarding the issues raised in this consolidated docket.

4  
5 HAVE YOU FILED TESTIMONY PREVIOUSLY IN THIS CONSOLIDATED DOCKET?

6 On February 8, 2002, I filed direct testimony in Docket No. E-01345A-01-0822 regarding  
7 APS' request for a variance from the electric competition rules. Because that testimony  
8 contains comments that are still relevant to this proceeding, I am submitting it by  
9 reference herewith.

10

11 WHAT WAS THE THRUST OF THAT TESTIMONY?

12 I cited several reasons why AUIA believes that the competitive bidding provision of  
13 A.A.C. R14-2-1606 (B) is inappropriate and not in the public interest at this time because  
14 it would expose ratepayers and shareholders to significant risk.

15

16 IS THAT STILL AUIA'S POSITION?

17 Yes, but this proceeding has been turned upside-down and bifurcated and the terms of  
18 engagement have changed drastically. APS' request for a variance has been trashed  
19 and we are now dealing with the Commission Staff's attempts to rewrite the electric  
20 competition rules.

21

22 WHAT ARE YOUR CONCERNS ABOUT THIS PROCEEDING?

23 The first is procedural fairness. When APS and TEP requested variances, which are  
24 authorized by the rules, they were required to submit expert testimony and exhibits  
25 and respond to extensive discovery, including depositions. But when the Staff imposed  
26 its new list of issues on this proceeding, they weren't required to put their cards on the  
27 table. The parties were forced to respond contemporaneously to issues that were vague  
28 and without any evidentiary basis.

29 The second is the soundness of any decisions that can result from this bifurcated  
30 process. We are racing down one track (Track B) as if it has been ordained that there  
31 will be competitive bidding when, in fact, the discussion of bidding was aborted. At  
32 the same time, the issue of APS' transfer of its assets has been diverted onto a second  
33 track (Track A) as if it is an isolated issue unrelated to bidding.

1 The fact is that these two issues have been married as long as both have been part of the  
2 competition rules, and they cannot be separated except at great peril to the shareholders  
3 of PWCC. Yet this proceeding has been structured to prevent any dialogue about what  
4 happens to UDC assets if bidding goes forward and divestiture does not.  
5

#### 6 WHAT IS AUIA ADVOCATING IN THIS PROCEEDING?

7 AUIA insists that full and open consideration of the disposition of APS' generating  
8 assets must precede the commencement of any bidding process. In the context of the  
9 existing competition rules, APS must be allowed to transfer its generating assets to an  
10 affiliate if the Commission is determined to go ahead with competitive bidding for part  
11 of APS' load.  
12

#### 13 WHAT IS THE COMMISSION STAFF'S POSITION?

14 Generally, the Staff's position is that APS should not be allowed to transfer its assets  
15 until it has addressed a perceived condition of market power through a study and,  
16 presumably, mitigation measures. The way the Staff has framed its perception of  
17 market power, it is unlikely that mitigation could be achieved in the foreseeable future  
18 and certainly not before a 2003 bidding procedure. For example, the market power  
19 study required by Staff would have to address statewide transmission constraints and  
20 how they would be cured by the utilities.  
21

#### 22 WHAT IS THE STAFF'S POSITION ON BIDDING?

23 Their testimony is inconclusive at best. Staff witness Matthew Rowell asserts that "If a  
24 utility were to choose not to divest, the provisions of Rule 1606(B) likely would not be  
25 achievable." (Rowell P. 6) He also asserts that consumers should pay no more than  
26 they are paying today, regardless of the results of any bidding process. (Rowell, P. 7)  
27

#### 28 WHY IS THIS ISSUE IMPORTANT TO EQUITY OWNERS?

29 Assume for the sake of argument that APS could lose 20 percent of its load to other  
30 suppliers in a competitive bidding process. When the process is completed, that  
31 amount of APS' generation would no longer be used and useful and would be  
32 disallowed from rate base, assuming that it is in a regulated regime. That would be a 20  
33 percent blow to the shareholders' equity.

1 WHAT WOULD HAPPEN TO THESE ASSETS?

2 At this time we don't have a clue. We don't know which assets would be affected or in  
3 what proportion. If we don't know the answers, the financial community will begin to  
4 penalize the company when the bidding process is adopted. The fact is that the rules  
5 currently place 50 percent of APS' load and half of its assets at risk through bidding.

6

7 WHAT IS AT STAKE FOR THE COMPANY?

8 Its ability to survive by deploying its assets as market conditions require. PWCC must  
9 be able to manage its risk and its portfolio. It can't do that if its assets are frozen in  
10 regulation and chopped off intermittently like unwanted fingers and toes. The quasi-  
11 regulated regime proposed by the Staff and some other parties ultimately requires the  
12 Commission to dictate to APS' how it deploys its assets. AUIA believes that would be  
13 an illegal abuse of the Commission's authority and we will urge the company to resist it  
14 by every means possible.

15

16 DON'T THE RULES REQUIRE ARMS-LENGTH PURCHASES BY APS?

17 Yes. Beginning in 2003, APS and TEP are required to purchase all of their generation  
18 needs through arms-length transactions in the open market, 50 percent by competitive  
19 bidding.

20

21 CAN APS DO THAT WITHOUT TRANSFERRING ITS ASSETS?

22 It doesn't seem possible. How can you conduct arms-length negotiations with yourself  
23 over the price of your own assets and how do you manage a fair bidding process when  
24 your assets will dominate the bidding?

25

26 IS AUIA CONCERNED ABOUT MARKET POWER?

27 AUIA is concerned about anything that distorts a competitive market. Given the  
28 peculiar nature of the market for electricity, market power will always be a concern and  
29 it should be monitored, analyzed and mitigated or punished where necessary. Market  
30 power is also part of the natural course of things and it often gives rise to competition.  
31 At the end of the day, the control of market power will largely be vested in the Federal  
32 Energy Regulatory Commission (FERC) and the Regional Transmission Organizations  
33 (RTOs) that it regulates.

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HAVE DIFFERING VIEWS OF MARKET POWER BEEN EXPRESSED?

Yes. Market power is in the eye of the beholder. For example, Staff witnesses postulate that APS and TEP are subject to a "rebuttable presumption" of market power because they have operated as vertically integrated utilities serving transmission-constrained load pockets. For another, Craig R. Roach, witness for Panda Gila River, concludes from his own analysis that APS has market power in the Phoenix area. But his concern is transparent. His solution is to postpone the asset transfer until after APS has secured all of its standard offer needs in the competitive market. He claims that the amended Settlement Agreement requires the power purchase to come before divestiture. (Roach, P.4). Contrary to his assertion, the Settlement Agreement does not require the competitive purchase to precede the asset transfer, for obvious reasons. The events are meant to be contemporaneous.

WHAT IS APS' VIEW OF ITS ABILITY TO EXERCISE MARKET POWER?

APS' witness, Dr. William Hieronymus, conducted his own analysis using FERC formulas for measuring market power and concluded that APS passes those tests. His results directly contradict those of Dr. Roach. In other words, APS would argue that it lacks significant market power. What this demonstrates, of course, is that any mandated study of market power, no matter who does it, will be a source of endless disagreement.

HAS AUIA REACHED ANY CONCLUSION ABOUT MARKET POWER?

AUIA has no particular expertise on the subject of market power. It seems intuitive that a formerly vertically integrated utility may be able to exercise some market power. However, apart from Dr. Hieronymus' analysis, I am very dubious about these imaginary applications of market power in the context of Arizona deregulation. While there may be a theoretical basis for postulating the worst case, I'm not convinced that it would happen. It's one thing for a generator or marketer to exercise market power from outside a state like California or Nevada, but it's a different matter for an Arizona company to risk fouling its own nest.

1 First, as Dr. Hieronymus notes, most of APS' power acquisition will be through  
2 contracts and the simplest way to remove the incentive for market power is to tie up  
3 most of the incumbents' assets in contracts.

4 Second, some parties have been dismissive of FERC's alacrity, but where transmission  
5 access is concerned it is FERC's primary responsibility is to police equal access through  
6 its own rules and the protocols of its RTOs. FERC has the means to enforce equal  
7 access.

8 Third, as Kevin Higgins, the witness for Arizonans for Electric Choice & Competition  
9 (AECC) notes, the AISA protocols and the wholesale tariffs approved by FERC provide  
10 for mitigation of market power in must-run generation. Mr. Higgins also points out  
11 that market power has become a "front burner" issue at FERC. (Higgins, P. 5)

12 Last, and certainly not least, it is mind-boggling to believe that an Arizona UDC would  
13 risk the consequences of exercising market power in order to pay inflated prices to an  
14 affiliate while the prudence of its purchases rests with the tender mercies of the  
15 Corporation Commission. If anyone thinks that the Commission's rate-setting  
16 authority is less than a weapon of mass destruction, just ask Citizens Communications.  
17 That company has been trying for two years to collect unrecovered purchased power  
18 costs that now total some \$120 million. The company has not yet had the first minute of  
19 evidentiary hearings on its request.

#### 20 21 WHAT IS THE STAFF'S VISION OF COMPETITION?

22 That is hard to fathom. The Staff's testimony in this docket is both anti-competitive and  
23 naïve. On the one hand, they want the competitive environment to be risk-free for the  
24 consumer and on the other, they seem to want competition to occur only in a perfect  
25 world.

#### 26 27 WHAT DO YOU MEAN BY ANTI-COMPETITIVE?

28 Let my quote from Mr. Rowell's testimony at Page 6: "Regardless of the provisions of  
29 rule 1606(B), the Commission should consider measures that ensure that consumers are  
30 no worse off because of competitive procurement than they would have been under  
31 traditional cost of service regulation."

32 And on Page 7: "...the established cost of service for the utilities' existing general units  
33 should be used as the price to beat during competitive solicitations whether the utility

1 has transferred its generation assets or not. Generally, Staff does not believe it is  
2 appropriate for a UDC to procure power at a higher price than its own cost of service  
3 before transfer or its affiliate's cost of service after transfer."

4 Those are "heads I win, tails you lose" arguments. They are certainly not sentiments in  
5 support of a free market and its attendant risks. I thought they could have been  
6 authored by Karl Marx.

#### 7 8 ARE THERE OTHER PROBLEMS WITH THIS NO-RISK APPROACH?

9 There are several.

10 I don't know how you would accurately determine cost of service in time for any  
11 bidding process. APS hasn't had a rate case in years and its current rates were actually  
12 negotiated in the Settlement Agreement. Also, there are PWEC plants serving APS  
13 customers that aren't in the utility's rate base.

14 Mr. Rowell also implies that the bidding process could be phony. Otherwise, if APS  
15 received bids that were higher than its cost of service it would have to eat the difference  
16 if consumers are protected from paying more than today's cost of service.

17 It's also unclear how long this cost-of-service test would be in place: For one bidding  
18 round? Two rounds? Forever? If so, would APS have to mothball its power plants just  
19 in case prices rose and it had to return to cost of service?

#### 20 21 WHAT IS STAFF'S PERFECT WORLD?

22 Basically, it's a world without transmission constraints for anyone and no reliance on  
23 must-run generation. The totality of Staff testimony is that market power and barriers  
24 to competition will not disappear until transmission constraints have been eliminated,  
25 must-run generation can be bypassed and regional RTOs are planning and policing the  
26 grid. Staff doesn't assert directly that asset transfers and competitive procurement can't  
27 take place until the perfect world appears, but it's obvious they would prefer it that  
28 way. It is clear from the study recommendations that the incumbent utilities are  
29 responsible for developing and probably implementing solutions.

#### 30 31 WHAT IS STAFF'S VISION FOR TRANSMISSION?

32 It is subject to interpretation, but one can infer that the Staff's goal is to upgrade the  
33 transmission system in Arizona to the point that any conceivable merchant generator

1 can achieve unconstrained access to the Phoenix and Tucson load centers. In addition,  
2 the system should be able to negate the need for reliability must-run generation (RMR).  
3 Staff concedes that the transmission problems it identifies can't be resolved until at least  
4 the last half of this decade.

5  
6 IS THAT A REASONABLE GOAL?

7 On its face, a transmission system with the capacity and the reach to embrace every  
8 merchant generator that might want to serve Phoenix and Tucson is absurd. In  
9 addition, you would never get it sited and built. The Commission can't really compel  
10 anyone to build transmission and about half of the facilities in place today are owned  
11 by entities that aren't under Commission jurisdiction.

12  
13 WHO IS RESPONSIBLE FOR TRANSMISSION IMPROVEMENTS?

14 In theory, the Staff supports a collaborative process involving all sectors of the industry  
15 (Jerry Smith, P. 25), but it is clear that the last line of defense is to compel the incumbent  
16 utilities to build the system to accommodate other interests. For example, the staff  
17 wants the jurisdictional utilities to perform an economic study of RMR generation and  
18 expects the Commission to order the utilities to build facilities to resolve transmission  
19 constraints to eliminate RMR if that is in the consumers' best interest (Smith, P. 26).

20  
21 WHAT ABOUT MERCHANT GENERATORS?

22 Presumably, they would be included in a collaborative process, but the Commission has  
23 little leverage over them and, as Mr. Smith observes, they are currently engaged in a  
24 game of "chicken" where transmission adequacy is concerned (Smith, P. 24). The Staff  
25 proposes some additional transmission requirements for merchant plants that have not  
26 yet received siting approval (Smith, P. 26), but that can be viewed as closing the barn  
27 door after most of the horses have left.

28  
29 WHAT IS YOUR CONCLUSION ON BEHALF OF AUIA?

30 The Commission's rules and the 1999 Settlement Agreement with APS require the  
31 Commission to approve the transfer of APS' generation assets to a corporate affiliate.  
32 AUIA believes that the potential for market power is seriously exaggerated in Staff's  
33 testimony and that the litany of perceived market faults recited by Staff witnesses

1 would take years to overcome, if ever. It is clear from their no-risk approach that the  
2 Staff is not interested in free market competition that offers both risks and rewards.

3

4 If the Commission is persuaded that the risks are too great to allow divestiture, then it  
5 must forego competitive acquisition of power supplies. To do otherwise would require  
6 APS to deploy the assets of its shareholders according to the Commission's direction  
7 while all other generators would be free of regulation. That would be unfair to PWCC  
8 shareholders and an abuse of the Commission's authority.

9

10 Asset transfer was at the center of the Settlement Agreement, which has not only been  
11 upheld by the Arizona Court of Appeals but cast as an enforceable contract. We expect  
12 the Commission to live up to its word and abide by the Settlement Agreement and we  
13 expect PWCC to employ every legal means to enforce it.

14

15 DOES THAT CONCLUDE YOUR TESTIMONY?

16 Yes, it does.

17

18

19

20

21