EXCEPTION

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BEFORE THE ARIZONA CORPORATION 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 PROCEEDINGS CONCERNING THE ARIZONA INDEPENDENT SCHEDULING ADMINISTRATOR	DOCKET NO. E-00000A-01-0630
IN THE MATTER OF TUCSON ELECTRIC COMPANY'S APPLICATION FOR A VARIANCE OF CERTAIN ELECTRIC POWER COMPETITION RULES COMPLIANCE DATES	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

PANDA GILA RIVER, L.P.'S EXCEPTIONS TO RECOMMENDED OPINION AND ORDER

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Pursuant to A.A.C. R14-3-110(B), Panda Gila River, L.P. ("Panda") hereby submits the following exceptions to the Recommended Opinion and Order (hereinafter "Recommended Order") issued by the Chief Administrative Law Judge, Lyn Farmer, on July 23, 2002 in the Track "A" portion of these consolidated dockets. As more fully outlined below, with the exception of the finding that the Arizona wholesale power market is not "workably competitive" (Recommended Order at 23), Panda generally supports the Recommended Order. Panda differs, however, on the subtle but important point that the market will be competitive, so long as the Commission ensures that competitors have access to the market. With over 6,500 MW of IPP generation built or under construction, Arizona has sufficient competitors. Accordingly, the Commission need only ensure that those competitors have a fair opportunity to compete. Because the record shows that the market will be competitive, the Commission should allow divestiture sooner, continue to develop a fair and competitive procurement process, and provide Arizona ratepayers the continued benefits that the market will bring.

I. THE RECOMMENDED OPINION AND ORDER IS INCORRECT IN CONCLUDING THAT THE ARIZONA WHOLESALE MARKET IS NOT WORKABLY COMPETITIVE.

In Finding of Fact Nos. 16, 25, 36 and 37, the Recommended Order concludes that the Arizona wholesale market is not "workably competitive;" that the Commission should stay Rule 1615(A), requiring separation of competitive assets, at least until July 2004, or such later time as the market can be shown to be competitive; that the Commission should stay Rule 1606(B), requiring competitive procurement of Standard Offer Service requirements, apparently until the conclusion of Track B of this proceeding; that because the market is not competitive, reliance on the market would not mitigate APS's s and TEP's market power; and that because the market cannot mitigate market power, the Commission should require APS and TEP to file market power studies and market power mitigation proposals. Recommended Order at 23, 28-29.

The Recommended Order appears to be based, at least in part, on the conclusion that the Arizona market is susceptible to the same problems that plagued California's market restructuring experience, insofar as "[e]ven today, there is not agreement amongst economists, much less regulators, as to why and what happened in California, and how to prevent a similar or related occurrence." Recommended Order at 22. There is, however, not a word in the record that would support a finding, or even a contention, that any of the factors that contributed to California's energy crisis are present or would ever be likely to occur in Arizona if divestiture and/or wholesale competitive procurement were to proceed.

Panda submits that the record in Track A shows that the wholesale market in Arizona will be competitive with appropriate Commission action. The Recommended Order concludes that the market power studies proposed by Panda witness Dr. Craig Roach "do the best job of analyzing the market conditions/structure in Arizona and in current load pockets." Recommended Order at 21. Based largely on Dr. Roach's analysis, the Recommended Order concludes that APS has market power, which would be transferred to its affiliate upon divestiture. However, Dr. Roach's conclusion was not based on the lack of competitive supply, but instead on the fact that APS has the ability, through control of its transmission system and its proposal for a self-dealing contract with its affiliate (the proposed PPA), to deny competitors access to the market. So long as the Commission ensures that competitive generators like Panda have access to the market, significant generation will be available, making the wholesale market in Arizona "workably competitive."

The record contains voluminous unrebutted evidence that significant competitive generation either is currently operating or will be online prior to the peak summer season in 2003. Panda's 2,080 MW Panda Gila River facility will be fully operational by August 2003. Declaration of David A. Crabtree (Exh. Panda-4) at 4. Reliant and Harquahala also both presented unrebutted testimony regarding their competitive facilities. Direct

Testimony of Curtis Kebler (Exh. Reliant-1); Rebuttal Testimony of Thomas Broderick (Exh. HGC-1). Dr. Roach testified that, by the end of 2003, more than 6,500 MW of competitive generation would be available, in addition to nearly 4,000 MW of import capacity. Exh. Panda-2 at 7. Indeed, APS's s own witness, Dr. Hieronymus, concedes that "the load of the market can be met without any recourse whatsoever to Pinnacle West resources." Tr. at 925. Dr. Hieronymus also maintained that Arizona faces a potential glut of generation beginning in 2004. Tr. at 941. APS further conceded that it will need to purchase significant additional power from the market to meet its power requirements. Tr. at 962. Presumably, these purchases will be at market rates. In short, no witness disputes the premise that significant competitive generation will be available in 2003. As Dr. Roach concluded, APS has market power, but this is not attributable to the absence of potentially competitive supply, but rather to the lack of any real opportunity for that supply to compete with APS. The record is clear and undisputed on this point – so long as competitive generators like Panda have access to the APS market, significant generation will be available to meet utility requirements, and the wholesale market will be competitive, considerably more so than if APS were not required to competitively procure all or a portion of its requirements from the wholesale market.

The unrebutted testimony also shows that so long as APS is held to its obligations under Arizona and federal law, existing transmission constraints should not limit the potential competitiveness of the Arizona wholesale power market. Under federal law, network transmission rights belong to the load, not to the generator. If APS has currently reserved transmission capacity to serve its native load and is serving that load from its existing generation, that capacity is equally available to any competitive generator selected through the competitive procurement process to serve APS's s Standard Offer Service requirements. APS witness Cary Deise agreed with this conclusion, testifying that "network transmission rights to serve APS's native transmission load will follow that

load. Thus, if Duke or Panda [or some other generator were to] provide service to APS's native load, they would have network transmission rights. If PWEC provides that service, it would have network transmission rights." Tr. at 1106.

These network transmission rights do not necessarily mean that at all times and under all circumstances competitive generators outside the Phoenix load center will be able to move power to the Valley during constrained periods but, as APS further concedes, the competitive generators will be at least as able to serve APS's s load as are APS/PWEC units located outside the load pocket, such as Redhawk. APS witness Deise agreed that there is no difference between an APS or PWEC unit interconnected at Palo Verde and any other generator able to reach the Palo Verde switchyard. Mr. Deise testified that "from a transmission viewpoint, I won't know the difference. To me, you will look like a generator that belongs to the . . . old APS, I will not know the difference." Tr. at 1107.

Therefore, all the evidence in the record indicates that significant competitive generation will be online in 2003, enough to serve all of APS's s load without recourse to APS's s own generation, and that this competitive generation (including PWEC) will have the same access to network transmission rights as does APS itself when serving this native load. In other words, APS will have a "workably competitive" market. Hence, there simply is no support in the record for the assertion that the wholesale market would not be sufficiently competitive so as to allow divestiture to occur, or to allow competitive procurement to proceed.

Finally, Panda notes that Finding of Fact No. 29 concludes that "[c]ontrary to the parties' expectations and assumptions, the wholesale market has faltered, the new competitors have failed to materialize, and incumbent utilities have not lost customers in any meaningful number." In context, inasmuch as Finding of Fact No. 28 refers to the parties' expectations regarding the retail market, it appears that the reference to wholesale

markets was meant to be a reference to the retail market. To the extent that this reference was intended to be to the wholesale market, Panda submits, for the reasons stated above, that numerous competitors have materialized to support a wholesale market which has not "faltered."

II. THE RECOMMENDED OPINION AND ORDER IS INCORRECT IN CONCLUDING THAT COMPETITIVE PROCUREMENT WOULD NOT MITIGATE MARKET POWER.

The Recommended Order agrees with Dr. Roach that APS's s existing market power must be mitigated before the transfer of its generation assets to its affiliate moves forward. However, the Recommended Order does not follow Dr. Roach's prescribed solution that competitive procurement is the appropriate way to mitigate such market power, but instead concludes (in Finding of Fact No. 21) that "APS and TEP's market power cannot be mitigated through competitive procurement at this time." By failing to adopt Dr. Roach's recommendation, the Recommended Order will not result in Arizona's Standard Offer Service ratepayers recovering the full benefits of the competitive market.

The Recommended Order discounts competitive procurement as a mitigation measure based on the erroneous determination that the wholesale market is not currently "workably competitive." As discussed above, the record shows that the Arizona wholesale market has plenty of suppliers to make the market workably competitive (assuming they are allowed to access the market), and that the best way to usher in more competition is to allow competitive procurement well into the future.

Nonetheless, the wholesale market need not even be fully competitive to act as a check on market power. It was generally accepted by all parties to this proceeding that market power is the ability to profitably maintain above-market prices. Recommended Order at 7. Consumers are harmed when a dominant player exercises its market power by being forced to pay higher prices than would otherwise prevail in a competitive situation. Tr. at 723. Consequently, so long as some market participants are able to offer

competitively priced power at least some of the time, the competitive prices will "test" any contracts or offers to sell power between UDCs and their generation affiliates. As Dr. Roach discussed, the harm and the remedy are the same, whether the Commission calls this market power, affiliate abuse, imprudent procurement or something else altogether. Tr. at 723. In all cases, the harm to Standard Offer customers is the same – paying too much for electricity, and not achieving the proper desired mix of risk, reliability and environmental conditions. Even APS's s witnesses concede the harm is similar. Tr. at 953.

Competitive procurement can mitigate market power even if the market is not wholly competitive, so long as the procurement process itself is competitive. Designing a workably competitive procurement process, including any necessary transitional mechanisms and rules, is the stated purpose of Track B. Put simply, as long as the Commission approves a process that is independently administered, fairly operated and impartially scored, with equal opportunity for all suppliers to participate, the procurement process itself will mitigate market power by testing all contracts against the market, even if the market itself is not 100% "workably competitive." And by testing any affiliate deal against the market, as established by the competitive procurement process, the Commission can ensure that ratepayers are not harmed by such deals by determining that such purchases are prudent.

The Recommended Order recognizes that competitive procurement delivers to ratepayers the benefits of the new Arizona generation resources. Recommended Order at 29. To the extent that Track B will allow consumers to reap the benefits of Arizona's new power plants, as suggested in the Recommended Order, presumably this would be attributable to the lower prices that would result from newer, more efficient and cleaner facilities offered by competitive suppliers, allowing APS to retire older, dirtier and less environmentally-friendly facilities.

Thus, the first step in mitigating market power is to implement the Order's recommendation that APS and TEP acquire, at a bare minimum, all power needs each cannot produce from its own assets. The Commission should require that power needed to serve incremental load growth, including any load APS intended to serve with the Pinnacle West merchant plants (Redhawk and West Phoenix), plus load from certain of APS's s older plants that can be replaced by newer, cleaner generation, be procured via a competitive procurement process. That competitive procurement process will then determine whether the transfer of Redhawk and the new West Phoenix units is prudent, and, if so, under what price and non-price terms these units' power will be sold back to APS. This is, however, only the first step. The initial procurement should be followed, in relatively short order, by additional competitive procurement, leading to competitive procurement of 100% of the UDCs' Standard Offer Service requirements within no more than a few years, as determined in Track B. By providing a fair forum for competitors to access the wholesale market, competitive procurement will mitigate market power.

The Recommended Order, in Finding of Fact No. 27, concludes that APS and TEP should submit market power studies and proposals to mitigate market power. For the reasons discussed above, this is both unnecessary and inefficient insofar as it would consume resources better directed toward designing a fair competitive procurement process in Track B and administering an auction or RFP.

III. DELAYING THE EFFECTIVENESS OF RULES 1606(B) AND 1615(A) BEYOND THE IMPLEMENTATION OF TRACK B IS UNWARRANTED.

The Recommended Order, in Finding of Fact No. 35, calls for the Commission to delay implementation of Rule 1615 until the Commission determines that the wholesale market is competitive, until at least July 2004. Likewise, the Recommended Order in Finding of Fact No. 36 provides that Rule 1606(B) should be stayed, apparently until the conclusion of Track B. The Commission should act now to set a timetable so that

competitors have a fair opportunity to compete.

For the reasons discussed above, competitive procurement mitigates any market power concerns, obviating the need to stay Rule 1615(A) beyond implementation of the procurement process established in Track B. Because the Commission's Track B schedule calls for a resolution prior to the requirement that APS obtain its Standard Offer Service requirements from the competitive market set forth in Rule 1606(B) (as modified by the 1999 Settlement Agreements), staying Rule 1606(B) is unnecessary.

IV. THE RECOMMENDED ORDER ERRONEOUSLY CONCLUDES THAT FERC HAS NOT DEFINED AN EFFECTIVE REGULATORY REGIME FOR WHOLESALE ENERGY MARKETS.

The Recommended Order, in Finding of Fact No. 26, concludes that the Federal Energy Regulatory Commission ("FERC") "has not yet defined or implemented an effective regulatory and oversight approach for competitive energy markets, so assurance is lacking that wholesale electricity prices are just and reasonable." To the contrary, FERC has established a regulatory regime that allows competitive wholesale markets to flourish while protecting captive customers from any remaining vestiges of market power. In 1996, FERC issued Order No. 888, which required, as a remedy for undue discrimination, that all public utilities provide open access transmission.

In 1999, FERC issued Order No. 2000, which encouraged all transmission-owning entities to place their transmission facilities under the control of a Regional Transmission Organization. And on July 31, 2002, FERC issued a Notice of Proposed Rulemaking ("NOPR") to "establish a standardized transmission service and wholesale standard market design that will provide a level playing field for all entities that seek to participate in wholesale electric markets." As FERC noted in the NOPR, under this wholesale market regime, public utility purchases increased from 18% of their total available electric energy in 1989 to over 37% in 2000.

In any event, the issue is not whether FERC has the ability to determine whether

wholesale prices are just and reasonable, to mitigate prices that are unjust and unreasonable, or to establish competitive markets in any geographic region. The issue is whether there are enough competitors to achieve a credible competitive solicitation. As discussed herein, by 2003, there will be more than 6,500 MW of competitive generation, along with APS's s and PWEC's existing generation, more than enough to allow a robust competitive solicitation. The Commission will maintain control over the procurement process, and can reject any and all proffered bids, effectively protecting against any effort to exert market power or to charge prices that are unjust and unreasonable.

V. CONCLUSION.

The Recommended Order is in many major respects very good. APS and TEP have market power, and this market power must be mitigated before generation divestiture is allowed. However, the Recommended Order does not take the final step. The wholesale market will have sufficient competitive generation to make the market competitive in 2003, so long as the competitors are given an opportunity to fairly access the market, thereby mitigating market power. The Commission should, therefore, modify the Recommended Order in this regard, and thereby prudently provide the full benefits of a competitive wholesale market to Arizona's Standard Offer ratepayers.

RESPECTFULLY SUBMITTED this 1st day of August, 2002.

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