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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 |

**POST-HEARING BRIEF OF PANDA GILA RIVER, L.P.**

FENNEMORE CRAIG
A PROFESSIONAL CORPORATION
PHOENIX

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Panda Gila River, L.P. ("Panda") hereby submits this post-hearing brief on the Track A issues of asset transfer, market power, code of conduct, jurisdictional issues, and Chairman Mundell's question regarding Arizona Corporation Commission ("Commission") jurisdiction in the context of a for-profit or not for-profit RTO. See Transcript of Hearing pp. 1462-1463. As more fully outlined below, the Commission's overriding goal of real consumer choice at the retail level is only achievable through a robust, competitive wholesale market. But Arizona ratepayers can, and will, benefit from the development of a robust wholesale market, whether or not retail choice ever develops in Arizona. As the Electric Competition Rules recognize, the road to achieving a robust wholesale market in Arizona is to require competitive procurement of all Standard Offer Service requirements customers. Accordingly, whether or not this Commission determines that divestiture is appropriate in the short term, it should reaffirm its commitment to competitive procurement.

## I. SUMMARY OF ARGUMENT

### A. Summary of Panda's Arguments

Panda's positions on the issues in this proceeding can be summarized as follows :

(1) As a general matter, Panda supports the proposed divestiture of Arizona Public Service Co. ("APS") and Tucson Electric Power Co. ("TEP") generation assets to an affiliate on the terms that were agreed to in 1999, namely, that the divestiture would be contemporaneous with competitive procurement. Without competitive procurement, Arizona consumers will not realize any benefit from APS's or TEP's expected divestitures. APS & TEP must be held to the deal they made in 1999. That is, divestiture of generation assets can be approved if, and only if, the sale of capacity and energy from those plants to Standard Offer customers is subject to challenge by competitors. Hence, competitive procurement for 100% of Standard Offer load was the agreed-upon *quid pro quo* for divestiture. Otherwise, Arizona ratepayers will pay too much for electricity, bear

too much risk, and have no guarantee of reliable performance. Accordingly, any divestiture of generation assets to affiliates should be conditioned on implementation of whatever competitive procurement framework is established in Track B of this generic proceeding. That was the deal in 1999, and it still should be the deal today.

(2) Competitive procurement will yield substantial benefits for Arizona ratepayers because there is an emerging oversupply of generation capacity in the near term. For example, APS's load is projected to be about 6,000 MW in Summer 2003. By that time, or soon thereafter, 6,500 MW of new competitive supply will be on-line in the APS service territory, in addition to the 6,000 MW controlled by APS. Put bluntly, there will be at least 12,500 MW of capacity competing to serve only 6,000 MW of load in APS' territory.

(3) Competitive procurement also is the means by which the Commission can maintain its jurisdiction over APS's generation procurement after divestiture. The Commission will approve and participate (through Staff) in the competitive procurement process. Only then will the contracts go to the Federal Energy Regulatory Commission ("FERC") for subsequent approval. Competitive procurement will become the Commission's tool for determining prudence.

(4) Competitive procurement also is the means by which APS's market power can be mitigated. If the market power of Utility Distribution Companies ("UDCs") and their affiliated generators is adequately mitigated, then each of the other issues identified by the Commission in its May 2, 2002 Procedural Order can be addressed with relative ease. The market power problem in Arizona is not that there are insufficient numbers of competitors, but rather that APS is in a position to foreclose competitors' from opportunities to compete. APS' effort to impose the Affiliate PPA on Standard Offer customers is, in-and-of-itself, an exercise of market power.

(5) Competitive procurement will benefit Arizona ratepayers with or without

divestiture. The Commission's duty is to ensure that utilities make prudent purchasing decisions, and that ratepayers are accorded the best deal possible. If competitive suppliers can provide a better deal to Arizona ratepayers than a utility's own generation, it would be imprudent to forego the opportunities provided by the market. Even leaving aside replacement of inefficient or environmentally undesirable generation owned by APS today, APS needs significant additional generation to meet its needs in the future. APS should not be allowed to meet these needs without a reasonable market test to determine whether its arrangements for doing so are in the public interest. Specifically, the new RedHawk and West Phoenix plants built by APS's merchant generation affiliate must be subject to challenge through competitive procurement to assure Arizona ratepayers are getting the best deal in terms of price, risk, and reliability. Neither of these plants has gone through prudence review and neither is in rate base.

(6) Vibrant wholesale competition is an essential prerequisite for successful retail competition. Whether or not Arizona moves forward with retail competition; however, Arizona ratepayers still will benefit from wholesale competition. But there can be no such competition without competitors and a meaningful competitive procurement program is necessary to have meaningful wholesale competition.

Panda therefore requests that the Commission allow APS's and TEP's divestiture of generation assets to an affiliate, conditioned on the Commission's approval of, and the affected utilities' implementation of, the competitive procurement process to be established in Track B of this generic proceeding. By conditioning divestiture on full competitive procurement, the Commission not only ensures that the *quid pro quo* for divestiture is achieved, but ensures that APS and TEP will continue to work in good faith to achieve a workably competitive procurement process.

Panda recognizes that the Commission itself, Staff and certain intervenors have raised concerns regarding the proposed divestitures. But as Panda witness Dr. Craig

Roach testified, those concerns can be addressed through a competitive bidding framework and an appropriate prudence review. Tr. at 726. And even if the Commission determines that divestiture is not in the public interest at this time, the Commission still should move forward with competitive procurement. Tr. at 824. The record in this docket makes it clear; Arizona consumers can benefit from competitive solicitation whether or not APS and TEP divest their generating assets. Admittedly Arizona's Standard Offer Service customers may receive the greatest benefit through divestiture and 100% competitive procurement, but they would substantially benefit from competitive procurement alone even if there is no divestiture.

### B. Summary of Panda's Response to the Arguments of Others

#### 1. Response to APS's Arguments

On the issues in the procedural order, APS's position can be summarized as: i) it has a contractual right, through the APS Settlement Agreement, to divest its generation to its affiliate; ii) it does not have market power; iii) no changes are needed in the code of conduct; and iv) the Commission's jurisdiction after divestiture is limited as to Pinnacle West and is limited to a "traditional" prudence review process as to APS. As to the contractual right to divest, Panda, which is not a party to the APS Settlement Agreement, takes no position. As Commissioner Spitzer noted, however,

> [t]he analytical underpinning of the original variance request and purchased power agreement was predicated on the idea that under the status quo there would be market power exercised by APS for various reasons, including transmission constraints; that the rules that this Commission had adopted would be insufficient to protect Arizona ratepayers, hence the request for variance and purchased power agreement. Your statements today appear to contradict that theory. So which is it? Are the rules that are currently in place, do they give rise to the exercise of market power by APS or do they not?

Tr. at 16-17. There is, therefore, a certain inconsistency in APS's position. It was APS, through its Request for a Variance, that came to this Commission and said it could not

live up to the Electric Competition Rules' mandate of 100% competitive procurement with at least 50% obtained by competitive bid. While APS presented evidence of the steps it took toward divestiture in reliance on the APS Settlement Agreement, the record is completely devoid of any evidence that it made reasonable, timely efforts to comply with the requirement to competitively procure power for its Standard Offer Service requirements. There was no evidence that APS ever issued an RFP, made a competitive solicitation on any significant scale for any period following entry of the APS Settlement Agreement, circulated its long-term energy or capacity requirements to any party, other than its merchant affiliate, to allow the market to be responsive to those needs, or otherwise sought a competitive alternative to its affiliate's construction projects.

Instead, APS "negotiated" a proposed non-arms-length, above-market, affiliate PPA that would all but eliminate the very Electric Competition Rules it agreed in its Settlement Agreement to implement. In fact, the testimony in this proceeding demonstrated that APS is relying on affiliate transactions to supply needs in 2002, again without any apparent effort to solicit those needs from the competitive market. Tr. at 1149. While APS may rightfully say that the Electric Competition Rules did not require it to take any specific action to promote the viability of electric competition in Arizona, it simply cannot have it both ways. Its claimed reliance on the Settlement Agreement to its alleged detriment, therefore, should not form the basis for moving forward with the divestiture if the Commission finds that APS did nothing to ensure its ability to live up to the other portions of the Settlement Agreement. In short, divestiture should move forward as Panda proposes, contemporaneous with 100% competitive procurement.

APS's position on market power is also ironic. It claims that it does not have market power because of a vast wholesale market and over 11,000 MW of import capacity, Tr. at 924-925; Hieronymus Direct Testimony (Exh. APS-4) at p. 34 lines 18-19, yet, in virtually the same breath, claims that it cannot competitively bid because of a

lack of competitors and existing transmission constraints. Tr. at 927. APS's expert concluded that APS would not have market power under the FERC Supply Margin Assessment ("SMA") test. Hieronymus Direct Testimony (Exh. APS-4) at 28; Tr. at 924. However, Staff witness Davis Schlissel bluntly testified that Dr. Hieronymus did not appropriately apply the SMA test to APS and his analysis contained inconsistencies. Schlissel Rebuttal Testimony (Exh. Staff-9) at 1, 3. Dr. Roach, after adjusting the SMA to make it functionally useful, concluded that APS does have market power. Roach Direct Testimony (Exh. Panda-2) at 9; Tr. at 723. Staff witness Schlissel agreed with Dr. Roach's analysis. Schlissel Rebuttal Testimony (Exh. Staff-9) at 5-6.

APS's response to Dr. Roach's adjustments to the SMA was not to challenge the need for the changes, rather, merely to note that the FERC test did not require Dr. Roach's revisions. Tr. at 920. This case is not yet before the FERC. Therefore, APS's proposed divestiture is within the jurisdiction and control of this Commission and it is up to this Commission to define market power in a way that is relevant to Arizona, and to the UDCs' Standard Offer Service customers. The test adopted must account for the fact that APS is able to push aside competitors with its Affiliate PPA, thus providing no forum for those competitors to compete for APS' load. In this regard, as Dr. Roach testified, whether you call it market power or affiliate abuse or imprudence, the harm to consumers is the same. Tr. at 723. In short, the market power analysis conducted by Dr. Roach is done in a way that is meaningful for APS's Standard Offer Service customers and finds that APS has market power that it will divest to its affiliate. Roach Direct Testimony (Exh. Panda-2) at 8-9. Staff witness Schissel reached a similar conclusion and supported the revisions called for by Dr. Roach. Schlissel Rebuttal Testimony (Exh. S-9) at 5. Thus, the Commission should determine that APS has market power today, and that its affiliate will have market power in the future.

APS witnesses argue that even if the APS affiliates have market power after

divestiture, the proposed PPA adequately mitigates the affiliates' market power. Davis Direct Testimony (Exh. APS-1); Tr. at 79. Testimony in this proceeding shows, however, that the variance associated with the PPA would harm competition, and the PPA itself is not in the public interest. Roach Direct Testimony (Exh. Panda-2) at 5; *see also*, Direct Testimony of Craig R. Roach, filed in Docket No. E-01345A-01-0822 at 17-35. As the APS experts grudgingly conceded, to the extent that the PPA results in prices or non-price terms above or worse than what would prevail in the competitive wholesale market, the harm to consumers from the PPA is the same as if it were a function of market power. Tr. at 953. If the above-market, self-dealing PPA is the only way to mitigate the market power of APS affiliates, then the Commission should reject divestiture. Rejection of divestiture is unnecessary, however, because competitive procurement adequately mitigates market power.

APS further denies that there is any need for changes to its code of conduct. Davis Direct Testimony (Exh. APS-1) at 12. The proposed PPA, and the "negotiations" leading to it, demonstrates that the contrary is true. Mr. Davis' testimony makes it clear that Commission Staff is rightfully concerned about code of conduct issues. And whether or not by Mr. Davis always would be guided by concern for the company's customers, Tr. at 231, there should never be a situation where APS's and its affiliates' fates are determined by the same individual on an issue effecting APS Standard Offer Service customers. Mr. Davis argued, in fact, that APS can never deal with an affiliate other than through a single individual, because in a company of APS's size, "somewhere along the line all the funnels have got to reach somewhere, and I happen to be that person." Tr. at 138. If this is true, then the original divestiture rule requiring divestiture to a third party was the proper approach to divestiture; not divestiture to an affiliate. Because it was APS that pressed for the ability to divest to its affiliate, APS bears the burden of showing that it can be done without compromising the independence of APS

as the purchaser for Standard Offer Service customers. If it cannot, it should be barred from dealing with affiliates.

Although the above issues were the ones addressed in the procedural Order establishing Track A, APS introduced significant testimony going well beyond Track A, apparently in an effort to prejudge future proceedings. In this regard, whether Pinnacle West Energy Corp's ("PWEC") merchant facilities (*i.e.*, Redhawk 1 and 2 and West Phoenix 4 and 5) should be included within the APS generation portfolio and determined to be prudently constructed facilities to meet APS's needs if the Commission ultimately determines that APS ultimately should not divest its facilities, is not before the Commission at this time. APS asked numerous questions of Staff witnesses on such issues and the "prudence" standard to be used to judge that issue and repeated an unproven mantra that the PWEC merchant facilities were constructed "for the benefit of APS customers." Tr. at 130. Simply put, the PWEC merchant facilities will only benefit APS ratepayers if they are less expensive than what the market can provide. If the Commission determines that divestiture is not appropriate, the Commission should still require competitive solicitation for APS's needs in the future. It is only through such a solicitation that the Commission can determine whether it is in APS's ratepayers' interest to assume the multi-billion dollar burden of APS's affiliate construction projects or to purchase their requirements under one or more long term contracts from unaffiliated entities.

**2. Response to Staff Arguments**

On the most important issues, Panda and Staff are in agreement. Panda agrees that APS has both generation and transmission market power, and that this market power will simply be transferred to PWEC with the asset transfer unless the Commission implements effective mitigation. Panda also agrees that a broader Code of Conduct is required to govern Affiliate transactions. And Panda agrees that the proposed Affiliate

PPA is not the best deal for Arizona ratepayers. Where Panda and Staff apparently differ is in next steps. On market power, Staff calls for additional studies and submissions. Panda has no problems with this, but believes additional market power studies are unlikely to reveal anything that Dr. Roach and Staff's witness Mr. Schlissel have not already identified; namely, that APS has market power because it can foreclose competitors. More importantly, the Commission must focus on how to mitigate that market power. As Panda suggests, the Commission should focus on competitive procurement as mitigation.

The Commission's focus should be on the potential for consumer harm and the potential for consumer benefit. As Staff has argued, APS's proposed PPA is a recipe for long-term consumer harm. Competitive procurement on the other hand is the foundation for consumer benefit. Panda and Staff apparently disagree, not on this premise, but on the timing of 100% competitive procurement. Staff has raised numerous concerns about moving to 100% competitive procurement in the near-term, including the depth of supply and transmission constraints. Panda believes Staff's concerns can better be addressed with staggered on-line dates, rather than by delaying of competitive procurement altogether. That is, APS can proceed with competitive procurement as called for in the Settlement, but APS will accept the best offers even if the on-line dates extend to 2004 and 2005.

### 3. Response to RUCO

While the positions of APS and Staff are at least understandable even where Panda disagrees, RUCO's positions are not. As the evidence indicates, nearly three years ago RUCO signed the APS and TEP Settlement Agreements as a party, thus supporting divestiture and the competitive procurement upon which they were premised. As Commissioner Irvin pointed out in his dissent to the approval of the settlement, RUCO supported the settlement without a single bit of analysis that it was a good deal

for residential consumers, merely RUCO's belief that it was. Now, three years later, RUCO would reject that same settlement and the electric competition rules upon which it was based, again without any analysis as to why. Instead of providing real support for its position, RUCO's witness Dr. Rosen would have the Commission Staff and the parties engage in a "path-breaking" study process to determine the potential for market power abuse. While the Nash Equilibrium Theory may make for an interesting movie (and provide its creator with a Nobel Prize), it is meaningless in helping this Commission do its job. This Commission should focus on mitigating market power that may exist, not on developing what Dr. Rosen says no one else in America has been able to develop, a perfect market power test.

## II. ARGUMENT

### A. Introduction And Procedural Background

#### 1. Description Of Panda Gila River, L.P.

Panda is a joint venture of Panda Energy International and TECO Power Services Corporation. Declaration of David A. Crabtree (Exh. Panda-4) at 2. Panda is constructing four gas-fired combined-cycle generating units with a combined capacity of over 2000 MW near Gila Bend, Arizona. Id. at 3. The first unit will come on line beginning in the first half of 2003, and all units are scheduled to be fully commercially operational by August 2003. Id. at 4. Panda has been approved by the Federal Energy Regulatory Commission ("FERC") to sell wholesale power at market-based rates. *Id.* at 2; Panda Gila River, L.P., FERC Docket No. ER01-931-000 (March 14, 2001) (letter order approving market-based rate tariff). As described in the testimony of Commission Staff witness Jerry Smith, the Panda facility is uniquely situated from a reliability perspective in that it is connected to the transmission grid through two lines, one to the newly constructed Jojoba substation and one to the Liberty substation. Tr. at 1477, lines 7 – 9. Through these interconnections, Panda can serve the APS, TEP, Salt River

Project ("SRP") and Western Area Power Administration ("WAPA") markets, as well as other points north and east. Exh. Panda-4 at 4-5.

### 2. Procedural Background

This proceeding follows, at least in part, from APS's Request for a Partial Variance from Rule 1606(B) of the Commission's Competition Rules, which otherwise requires UDCs, having separated their competitive services, such as generation, from noncompetitive services, such as distribution and transmission, to competitively procure 100% of their Standard Offer Service requirements, with at least half through competitive bids. A.R.S. § 40-1606. APS asked the Commission to exempt it from this requirement and approve a Purchase Power Agreement ("PPA") with an initial term of up to 13 years, with three 5-year renewals between APS and Pinnacle West Capital Corp. ("PWCC"). PWCC would in turn purchase power from PWEC, the affiliate to whom APS proposed to transfer its competitive generation facilities.

Many parties, including Panda, opposed APS's request for a variance from the Competition Rules and the associated PPA, arguing that APS did not support its assertion that the competitive market could not supply APS's Standard Offer Service requirements, that a competitive wholesale market remained in the public interest (as the Commission determined it to be in promulgating the Competition Rules, including Rule 1606, in the first place), and that APS's proposed PPA was not in the best interest of APS's ratepayers. In addition, Commission Staff argued that allowing APS to transfer its generation assets to PWEC would allow PWEC to exercise market power to the detriment of the market and of APS's ratepayers.

Ultimately, the Commission stayed the hearing scheduled on APS's variance request, electing to proceed with an examination of electric restructuring in Arizona, including an analysis of the ability of UDCs or their generation affiliates to exercise market power, the appropriate remedy for such market power (if it exists), whether to

permit the transfer of generation facilities from a utility to an affiliate remained in the public interest, and the rules, standards and regulations governing competitive procurement of Standard Offer Service by Arizona UDCs. See, In the Matter of the Generic Proceedings Concerning Electric Restructuring Issues, Docket No. E0000A-02-0051, Procedural Order (May 2, 2002).

The Commission's order staying the APS variance proceeding and instituting this generic examination of electric restructuring divided the proceeding into two "tracks." This Track A was instituted to address "the issues identified in Staff's April 23, 2002 Response to [APS's] Motion for Determination of Threshold Issue – the transfer of assets and associated market power issues, as well as the issues of Codes of Conduct, the Affiliated Interest Rules, and the jurisdictional issues raised by Chairman Mundell." Id. at 1-2. Track B, examining all issues related to competitive procurement, will proceed concurrently, with an anticipated Commission order no later than October 21, 2002. *Id.* Therefore, while the Commission's determination of competitive solicitation issues in Track B will determine whether its decision in Track A is effective and provides real benefit to ratepayers, the Commission should not determine in Track A how much and in what manner to rely on the competitive market to supply Standard Offer Service requirements. In Track A, the record properly reflects only issues relating to asset transfer, market power, mitigation of market power, the Code of Conduct, the Affiliate Interest Rules and the Commission's ability to address these issues within its applicable jurisdiction.

### B. Divestiture is Appropriate If Market Power and Code of Conduct Issues are Addressed Before Allowing Divestiture

Panda favors divestiture with appropriate consumer safeguards in place to prevent the exercise of market power by the UDC affiliate. APS argues, however, that such safeguards are not necessary and asset transfer is a "done deal" because the Commission

has already determined that asset transfer is in the public interest, first in promulgating the Competition Rules, and later in approving the 1999 APS Settlement Agreement that resolved numerous challenges to the Rules. Davis Direct Testimony (Exh. APS-1) at 5. APS further argues that revoking its authority to transfer its assets to PWEC would be a breach of the Agreement and would harm APS's credit rating. Id. at 6-8.

APS is correct that the Commission determined asset transfer was in the public interest. The Commission determined that wholesale and retail electric competition in general, of which asset transfer is but one part, were in the public interest. In the Matter of Competition in the Provision of Electric Services Throughout the State of Arizona, Decision No. 61969 (September 29, 1999) at 6. In fact, it was the potential benefits from competitive procurement and competitive markets that were the driving principles behind the Commission's decision. *See,* , *In The Matter Of The Competition In The Provision Of Electric Services Throughout The State Of Arizona*, Decision No. 60977 (June 22, 1998)("In the long-run, it is believed that competition will result in lower prices, better service, more choices and increased innovation."). APS's expert, Dr. William Hieronymus, supported the Commission's analysis, testifying in this proceeding that

> [t]he benefits of a competitive wholesale market flow primarily from three causes. First, the progressive movement from cost of service to market pricing produces powerful efficiency incentives that did not exist previously. . . . Second, a competitive wholesale market allows customers to benefit as competition among efficient generators drives down prices relative to what they would have been under continued monopoly regulation. Third, a competitive wholesale market is an essential underpinning of retail competition and, with it, the product and pricing innovations that retail competition can produce.

Hieronymus Direct Testimony (Exh. APS-4) at p. 2 line 21 – p. 3 line 10. Thus, the key

to consumer benefit is a competitive wholesale market, not asset transfer. Asset transfer only supports the development of a competitive wholesale market if the new UDC, devoid of generation, is required to go to the competitive marketplace to fill the needs of its Standard Offer customers.

APS had, until its variance request, not only recognized that asset transfer and competitive procurement were part of a comprehensive set of rules but had also unmistakably tied its asset transfer to competitive procurement. APS witness Jack Davis unequivocally told the Commission in an open meeting in September of 1999, before approval of the APS Settlement Agreement upon which APS so heavily relies, that "after APS divests its generation, 100% of Standard Offer load will be obtained from the competitive market." Minutes of September 1999 Special Open Meeting (Exh. Panda-1) (emphasis added).

Panda agrees, therefore, that divestiture of generation facilities by a UDC to its affiliate is not per se improper. As part of a comprehensive restructuring of the electric market, it is generally a good idea to separate control of competitive functions from control of essential delivery functions, so long as market power concerns are addressed, rather than simply transferred with the assets.

### 1. Divestiture of Generation Is Appropriate Only If Market Power or the Potential for Affiliate Abuse are Mitigated

The testimony presented in this proceeding demonstrates that APS has market power in its service territory, and will transfer that market power to its affiliate upon divestiture. Roach Direct Testimony (Exh. Panda-2) at 10; Schlissel Direct Testimony (Exh. S-8) at 8. Even APS concedes that it is able to exercise market power, at least some of the time in a portion of its territory. Tr. at 77; Hieronymus Direct Testimony (Exh. APS-4) at 28. APS's own witness, Jack Davis, testified that

> Q. You don't believe, do you, that APS or PWEC can

> exercise market power?
>
> A. I think, as I said in my statement in terms of load pockets, we surely can. I don't think anybody is arguing with that. But that will come and go over time.

Tr. at 77. Despite this, APS argues that market power does not exist in any manner the Commission should worry about. Alternatively, APS argues that the Commission should not worry as its sweetheart affiliate deal will mitigate any market power that exists. Dr. Roach testified that "APS has both transmission and generation market power in both the APS Market as a whole and in the APS Valley Market. APS' generation market power in the market as a whole would continue if the Affiliate PPA were approved, effectively blocking competition from third-party suppliers." Roach Direct Testimony (Exh. Panda-2) at 16. Dr. Roach testified that, in fact, the proposed PPA itself is an exercise of market power as it would result in price and non-price terms above levels that could be obtained from the competitive market. According to Dr. Roach, "the variance and the PPA are an attempt to foreclose this opportunity to compete, and yes, I believe that if the affiliate PPA went forward, that the result would be higher prices, higher risk, lower reliability." Tr. at 753. Staff witness David Schlissel testified that the PPA could "'lock-in' purchasers to paying higher than competitive prices over long periods of time." Schlissel Rebuttal Testimony (Exh. Staff-9) at 3.

The APS experts challenged this conclusion, arguing that the PPA was arrived at outside the market and thus does not establish market power. Hieronymus Rebuttal Testimony (Exh. APS-5) at 3. Dr. Hieronymus asserted that the proposed affiliate PPA mitigates market power because it ties up the generation assets and prohibits them from participating in the market. Id. at 4. Dr. Roach explained the fallacy of this argument as follows:

> And the reason is obvious, the PPA - - if I found someone in the spot market charging $5,000 a megawatt hour, and I said that's an exercise of market power, I take no comfort if the guy says okay, okay, I'll sign a long-term power purchase agreement, then I'll say to him what's the price, and he says $5,000. The PPA by itself doesn't mitigate market power; you have to have the price challenged by the marketplace.

Tr. at 772-73. In an attempt to overcome this deficiency in its reasoning, both APS Counsel's questions to Dr. Roach, Tr. at 770-71, and Dr. Hieronymus' rebuttal testimony, Exh. APS-5 at 3, assert that the proposed APS affiliate transaction cannot be an exercise of market power as the transaction must be approved by the Commission. Dr. Roach rejected that assertion in the following way:

> Q. Normally, when competitors wish to exercise market power, they don't go to regulators and ask approval, do they?
>
> A. I disagree with that. I think that in a regulated business, that a lot of the exercise of market power is done through proceedings. The ability to push aside competitors is very powerful. Its kind of the mother of exercises of market power, and that's what's being done here. So in a regulated business, I don't think that's true. I really believe regulated utilities can exercise market power. There are antitrust ones.

Tr. at 770. The experts were in agreement, however, that whether it is called market power, affiliate abuse or imprudence, the consumer harm is the same. Dr. Roach testified:

> I think the focus here should be is there an opportunity to do harm to consumers in the sense that they would end up paying a higher price or facing higher risks or facing lower reliability than they would have if they chose an alternative to APS. I really don't care that much if the route to that harm is characterized as an exercise in market power, affiliate abuse, or even if it's just called an imprudent decision. In all those cases, the same point is true, that APS has to prove that its deal is the best deal for ratepayers.

Tr. at 723. Dr. Hieronymus agreed that imprudence and exercise of market power both can cause consumers to pay higher prices than would be the case with a competitively priced offer. Tr. at 953. Dr. Cicchetti agreed that (assuming a divested UDC does not face unavoidable costs), the Commission should consider in its prudence review whether the UDC passed up lower-priced market alternatives in signing long-term contracts, because customers could otherwise be harmed. Tr. at 362.

In deciding whether to move forward with divestiture, the Commission should not get bogged down in the details of whether market power exists under one or another quantitative market power test. As described below, the proof on that issue is in the record. Nevertheless, focusing on such tests in the context of divestiture takes the focus away from the most relevant issue: how can Arizona Standard Offer Service ratepayers benefit from divestiture and, equally important, how can they be protected from harm. As a regulatory body, this must be the Commission's primary focus. As Dr. Roach explained, whether you call it market power, affiliate abuse or imprudence the harm is the same, as is the cure. Dr. Roach testified:

> I'm just making sure that we don't get caught up in a word game. The focus of this Commission has to be, and it is, on whether consumers are going to be harmed. And even if this Commission didn't feel comfortable taking the market power road, all these other roads lead to the same recommendation: Affiliate abuse or even imprudence.
>
> It's all about the Commission being sure that the consumer gets the best deal because APS adequately reviewed all the alternatives, and I think in today's world, competitive procurement is the way they get evaluated.

Tr. at 755. Thus, APS should be permitted to move forward with divestiture only if the cure, competitive procurement, is adopted and implemented.

### 2. Competitive Procurement Mitigates Market Power

As the testimony of Dr. Roach established, the Commission's best mitigation tool to ensure that APS/PWEC do not exercise the transferred market power is to require competitive procurement of APS's Standard Offer needs. Tr. at 724; Roach Direct Testimony (Exh. Panda-2) at 17. The Commission recognized this in 1999 and it is no less true today. Competitive procurement disciplines market power by testing it against the competitive market. This is also consistent with Commissions Staff's position that APS must produce results for consumers that mirror market prices if they are below cost of service.

As described above, competitive procurement as prescribed by the current electric competition rules helps to mitigate APS/PWCC/PWEC's market power in two important ways. First, to the extent that capacity needed to supply Standard Offer load is subject to a competitive bid process, APS and its affiliates are disciplined by the possibility that competitive suppliers will supplant the APS affiliate as supplier. Certain witnesses discounted this type of mitigation, and called for delay in full application of the Electric Competition Rules by asserting that competitive suppliers would be unable to supply all of APS's Standard Offer needs immediately. This argument misses the point. Competitive procurement is not simply a snapshot in time. APS has not proposed, nor is it expected, that APS would conduct a competitive procurement merely for needs over a one-year period. If APS did suggest competitive procurement limited to one year, such a procurement strategy would be imprudent.

A reasonable competitive solicitation process would establish APS's needs over a number of years and ask all available competitors to identify how they would fulfill those needs. Dr. Roach, for example, described a portfolio of contracts that would cover 5, 10 or even 15 years with varying start dates. Tr. at 764. Under this approach, the former APS generation in the hands of an APS affiliate would be appropriately incented

to make a competitive supply offer as generation which is unavailable in the first year may in fact be available and more cost effective in years 2, 3 or 4. Thus, the mere fact that merchant generation may not be available on January 1, 2003, does not preclude competitive procurement from acting as an effective mitigation tool for market power held by an APS affiliate. Tr. at 760 – 64.

In fact, had APS conducted a competitive procurement in 1999 for its 2003 needs, we would likely not be before the Commission right now. Instead, APS and its affiliate continued down a path of constructing affiliate-owned generation in the APS footprint. APS now seeks to protect its Affiliate's investment on the backs of it's Standard Offer Service customers – through divestiture of current APS generation assets and a PPA that includes the affiliate-constructed generation.

Application of the current rules also will mitigate any APS affiliate market power by requiring that competitive procurement that is done outside of a competitive bid must be done through a bilateral, arms-length transaction. The testimony of APS witness Jack Davis made it very clear that APS does not believe, under the current corporate structure for APS, that it can negotiate an arms-length transaction with an affiliate. Tr. at 263-64. In this regard, because the APS affiliate would be excluded from entering into a bilateral contract with APS, under the current rule, it cannot exercise market power.

### C. Even If The Commission Determines That Divestiture Does not Make Sense, Competitive Procurement Makes Sense

Even if the Commission decides that transfer of generation by utilities is not in currently the public interest, competitive procurement still makes sense. Tr. at 824. The Commission's duty is to ensure that utilities make prudent purchasing decisions, and that ratepayers are accorded the best deal possible. If competitive suppliers can provide a better deal to Arizona ratepayers than a utility's own generation, it would be imprudent to forego the opportunities provided by the market. Tr. at 953. If the market cannot

provide a better product than the utility's generation, Standard Offer Service ratepayers are best served by continued reliance on utility generation. The only way to determine what the market can do, however, is to allow competitive suppliers to tender offers through a well thought out and clearly defined competitive procurement process.

Although APS asserted that competitive procurement without asset transfer "does not make sense," allegedly because the utility would be competing against itself, Tr. at 133, experience from other states demonstrates that competitive procurement makes sense and provides benefits to ratepayers even without divestiture. Chairman Mundell referred on more than one occasion to the "Virginia Model," wherein the Virginia Corporation Commission required Dominion Virginia Power to conduct competitive bidding for new resources, even though Dominion had not divested its generation. Tr. at 224; *Application Of Virginia Electric And Power Company For Approval Of Expenditures For New Generation Facilities Pursuant To Va. Code § 56-234.3 And For A Certificate Of Public Convenience And Necessity Pursuant To Va. Code § 56-265.2* (Jan. 14, 1999) (attached hereto at Tab 1). Colorado and New Jersey, where utilities likewise retained their generation assets, also have conducted successful competitive solicitations. The evidence demonstrates that competitive procurement benefits both the markets and the ratepayers, whether or not utilities become UDCs by transferring their generation facilities. In fact, PWCC relied upon APS's obligation to engage in prudent third party purchases to replace inefficient generation as justification to FERC for certain of its trading activities in the California market. See Pinnacle West Response to FERC "Fact-Finding Investigation of Potential Manipulation of Electric and Natural Gas Prices," filed with this Commission in Docket No. E-00000A-02-0051, at 4-5. There is no justification why these purchases cannot be made under a long term contract arrived at as a result of a competitive procurement instead of reliance on the volatile California spot market.

## D. APS Has Market Power That Must Be Mitigated Before The Commission Allows Divestiture

### 1. APS Has Market Power in its Control Area

The Commission recognized in establishing this Track A proceeding, the existence and need for mitigation of market power as part of any divestiture of generation is a threshold issue upon which divestiture itself hinges. The Commission has several available alternatives in assessing whether APS currently has market power, or whether PWEC/PWCC will have market power in the APS service territory after divestiture, which could be exercised either by APS as an integrated utility or by PWEC if the Commission approves divestiture. Staff proposes that APS and TEP file market power studies with the Commission prior to divestiture. Rowell Direct Testimony (Exh. S-15) at 10-12. Other testimony in this proceeding discussed the Hirfindahl-Hirschman Index ("HHI") used by the U.S. Department of Justice to measure market concentration in assessing horizontal mergers, and the "hub and spoke" analysis traditionally used by the FERC to assess utility market power. Rosen Direct Testimony (Exh. RUCO-1) at 12. Panda witness Dr. Roach and APS witness Dr. Hieronymus each applied FERC's current market power test, the SMA, to APS. Roach Direct Testimony (Exh. Panda-2) at 5-14; Hieronymus Direct Testimony (Exh. APS-4) at 27. RUCO witness Dr. Rosen made clear his belief that no one in America has really performed the right market power analysis and this Commission and the parties should undertake a "path-breaking" study over the next year.

The definition of market power agreed to by nearly all testifying experts was that, as Dr. Hieronymus put it, "market power is the ability to profitably sustain an above-competitive price in the marketplace." Hieronymus Rebuttal Testimony (Exh. APS-5) at 3; Roach Direct Testimony (Exh. Panda-2) at 7; Talbot Direct Testimony (Exh. Staff-6) at 5; Rosen Direct Testimony (Exh. RUCO-1) at 4. As Dr. Roach testified, the harm to

consumers is not different if the above-market price is not technically market power but derives from affiliate abuse, imprudence or simply poor rules. Tr. at 723. Thus, Panda does not believe it is essential for the Commission to undertake exhaustive market power studies or even to study market power beyond what has already been presented.

If the Commission nevertheless deems market power analysis essential, the SMA test conducted by Drs. Roach and Hieronymus is the best approach to measuring APS's market power. Staff's proposal for market power studies has some merit, but at this point the content, format and purpose of the studies is unclear, and Staff has neither proposed clear standards for the market power studies nor proposed guidelines for the Commission to apply in assessing the filed studies. Other market power tests have similar weaknesses. The HHI index, although widely applied to determine market concentration in merger proceedings, has seldom been applied to determine the ability of an affiliated electric supplier to exercise market power in restructured markets. RUCO witness Dr. Rosen's proposed strategic behavior model based on Nash Equilibria is even more removed from practical application – no jurisdiction has ever applied such behavioral modeling, the models would have to be developed for the Arizona market, and Dr. Rosen concedes that application of his proposed model would require "a path-breaking study." Tr. at 1019; Rosen Rebuttal Testimony (Exh. RUCO-2) at 7.

The SMA test, while not without flaws, has been applied by FERC in situations very similar to the Arizona market. FERC initially applied the test to three large integrated utility systems – Entergy, Southern and AEP – and stated that it would apply the test to any entity seeking approval for, or renewal of, market-based rates that is not a member of an approved ISO or RTO. AEP Power Marketing, Inc., et al., Order On Triennial Market Power Updates And Announcing New, Interim Generation Market Power Screen And Mitigation Policy, 97 FERC ¶ 61,219 (2001). Because the SMA test has been applied by FERC to assess precisely the sort of market power at issue in this

proceeding, the Commission should use the SMA as a guide in assessing APS's market power.

The SMA is a "pivotal supplier test," which deems a supplier to have market power if it is pivotal to a market and thus has the ability to be a price mover in the market. Roach Direct Testimony (Exh. Panda-2) at 6. The test does this by calculating a market's supply margin, which equals the total supply into the market less the peak load in that market. Id. The supply margin measures the excess generating capacity in the market and available for import from adjoining ("first-tier") markets. Id. If a supplier's generating capacity exceeds the supply margin, the supplier could create shortages by withholding generation, and is therefore deemed to be "pivotal" and to have market power. Id. If a supplier controls less capacity than the supply margin, it could not create shortages, but could only reduce the available supply margin. Id. Such suppliers are not deemed to be pivotal, and FERC does not deem them to have market power.

Like any quantitative measure of market power, the SMA is an approximation, the details of which were criticized by several witnesses in this proceeding. Nevertheless, the basic premise of the SMA is sound – pivotal suppliers in a market have the ability to move market prices above competitive levels by control of supply. The Commission, therefore, should ensure that in applying the test, it accurately accounts for both supply and demand. Dr. Roach testified about three assumptions in FERC's application of the SMA that tend to overstate supply and, consequently, overstate supply margin. Id. at 8-9.

First, the SMA assumes that all in-region merchant generators are able to provide a competitive option. If, however, these suppliers are frozen out of the market, as APS is currently attempting to do through its variance request and proposed PPA, these suppliers may well have no market, and will be unable to contribute to APS's supply

margin. Id. at 8.

Second, the SMA includes all in-region generation, even though much of this in-region generation is likely to be committed to load. Id. at 8. This is particularly true in the APS region, which includes more than one utility with native load customers. For example, SRP generation is likely to be committed to SRP load, and therefore does not contribute to supply margin. Roach Direct Testimony (Exh. Panda-2) at 8-9; Tr. at 783.

Finally, the SMA assumes that a region actually imports the lesser of all capacity it is physically able to import or all capacity that is available for import at peak hours. Dr. Roach conservatively assumes that the level of imports matches the available transmission capacity. Roach Direct Testimony (Exh. Panda-2) at 9.

Each of these assumptions tends to overstate the supply margin, which results in an understatement of market power. The SMA, as applied by the FERC, does not adjust these factors, and thus could result in inaccurate results. The Commission, however, is not bound to the FERC version of the SMA, and should adjust the inputs of the test if necessary, even if the Commission generally agrees that assessment of pivotal suppliers is a practical approach to evaluating market power.

Panda witness Dr. Roach, adjusting the FERC SMA test for these incorrect assumptions, concluded that APS is a pivotal suppler in the APS region, and therefore has market power. Dr. Roach's analysis was as follows:

**THE SMA WHEN MERCHANTS AND NON-APS IN-AREA GENERATION CANNOT COMPETE IN THE APS MARKET (All values in MW)**

| | |
|---|---|
| In-Area Capacity | 5,390 |
| Imports | 3,900 |
| Total Supply | 9,290 |
| Projected Peak load | 5,911 |
| Supply Margin | 3,379 |
| APS Capacity | 5,705 |
| Pass/Fail SMA | Fail |

Id. at 9. Staff witnesses Neil Talbot and David Schlissel agreed with Dr. Roach's SMA analysis for APS. Talbot Rebuttal Testimony (Exh. S-7) at 3; Schlissel Rebuttal Testimony (Exh. S-9) at 5-6. Mr. Talbot concluded that "Dr. Roach's diagnosis of APS market power is similar to that of Staff." Exh. S-7 at 3.

APS witness Dr. Hieronymus also conducted an SMA analysis, and concluded that APS was not a pivotal supplier in its market and therefore did not have market power. Hieronymus Direct Testimony (Exh. APS-4) at 32. The Commission should disregard Dr. Hieronymus' analysis for two reasons. First, Dr. Hieronymus did not account for the SMA test's inherent overstatement of supply margin by considering available capacity (even generally) instead of existing capacity. Tr. at 942. More importantly, Dr. Hieronymus did not account for capacity that is foreclosed from competing by APS. That the test as formulated by the FERC does not address these inherent problems should not bind the Commission – unchecked exercise of market power by UDCs or their affiliates would directly harm the most risk-averse ratepayers, those who remain Standard Offer Service customers.

In addition, Dr. Hieronymus significantly overstated import capacity into the APS region by including transmission facilities that APS neither owns nor controls. Roach Rebuttal Testimony (Exh. Panda-3) at 11-12. This results in an increased supply margin, allowing Dr. Hieronymus to conclude that APS is not a pivotal supplier. From a credibility perspective, it is important to note that APS appears to ignore this very transmission capacity when arguing why there would be insufficient competitive response if the current competitive procurement rules are applied and why its variance request and PPA should be granted. Commissioner Spitzer commented on this apparent inconsistency in APS's position. Tr. At 16-17 As Dr. Roach testified, adjusting Dr. Hieronymus' approach with the appropriate parameters demonstrates that APS has market power. Roach Rebuttal Testimony (Exh. Panda-3) at 13.

### 2. APS Has Greater Market Power in the Phoenix Load Pocket

Dr. Roach also conducted a load pocket-specific SMA analysis for the Phoenix load center. Roach Direct Testimony (Exh. Panda-2) at 13-14. Transmission capacity into the Phoenix Valley is constrained at least some part of each year, limiting imports, which in turn decreases available supply and the resulting supply margin. Id. FERC does not require subregional SMA analyses, but region-specific market power studies are common in the electric industry. Dr. Roach performed two SMA analyses for the Phoenix Valley Market, each of which showed APS had market power. The first was a "standard" SMA analysis, which resulted in a supply margin of 996 MW and APS generation of 1,393 MW. Id. at 13. However, Dr. Roach subsequently assigned a portion of the TTC into the Valley Market to APS, because APS's in-Valley generation should include that portion of APS's generation outside the load pocket that APS can import into the region. Id. at 14. Dr. Roach's revised analysis was as follows:

**THE SMA FOR THE APS VALLEY MARKET**
**(All values in MW)**

| | |
|---|---|
| In-Area Capacity | 1,393 |
| Imports | 3,685 |
| Total Supply | 5,078 |
| Projected Peak load | 4,112 |
| Supply Margin | 966 |
| APS Capacity | 2,432 |
| Pass/Fail SMA | Fail |

Id. at 14. Dr. Roach's analysis shows that APS's market power in the Valley market is even more significant than its market power in the region at large. Staff witness David Schlissel testified that Staff agreed "with Dr. Roach's conclusion that APS has generation market power in the APS Valley Market [and] with Dr. Roach's observation that APS would fail the SMA test by even larger margins if its share of the transmission import capacity into the Phoenix Valley were considered." Schlissel Rebuttal Testimony (Exh. S-9) at 6.

APS concedes that the Phoenix Valley experiences load pocket conditions for at least some portion of the year, and that "in terms of load pockets, [APS] surely can [exercise market power]." Tr. at 77. Indeed, no party disputes that the Phoenix market is, at times, transmission-constrained and that APS has market power during such constrained periods. APS witness Dr. Hieronymus further stated that in the short-terms, APS will have market power due to a relatively limited number of competitors. Tr. at 964.

### 3. APS's Proposed PPA Perpetuates, Rather Than Mitigates, APS Market Power

APS witnesses have argued repeatedly that the PPA APS proposed in the variance proceeding, as a long-term contract based on allegedly cost-based rates, mitigates any market power concerns, because APS will be tied to contract rates and will be unable to influence the market price. See, e.g., Hieronymus Rebuttal Testimony (Exh. APS-5) at 38. APS's analysis is flawed for several reasons. First, as discussed above, the PPA excludes competitive suppliers from the Arizona market for a substantial period, which forecloses competition in the region and increases APS market power.

Second, the PPA's terms are unfavorable to ratepayers, providing higher prices, increased risk and fewer benefits than would a comparable, competitively-tested, market-based contract. Roach Direct Testimony (Exh. Panda-2) at 5 ("for a sustained period of time, Standard Offer Service customers would pay higher prices, face greater risks, and suffer lower reliability with PWEC service than they would if served by competing suppliers."). The PPA, as APS concedes, was not an arms-length, negotiated contract. Tr. at 197. Indeed, it is unlikely that there could ever be an arms length contract between APS and any of its affiliates – APS witness Jack Davis testified that he, or someone like him, would be the "final arbiter" for both parties to the agreement. Tr. at 138. Therefore, the PPA, containing terms that are worse for APS's Standard Offer

Service ratepayers than would be produced by the competitive market, is itself the result of APS's and PWCC's market power. Roach Direct Testimony (Exh. Panda-2) at 5. Finally, the PPA pricing terms, if they are higher than market prices, will cause harm to ratepayers, as Dr. Hieronymus conceded during the hearing (although Dr. Hieronymus said this would be merely imprudent, rather than an exercise of market power). Tr. at 952-953.

The PPA, resulting from and perpetuating APS's market power, harms ratepayers because it forces ratepayers to pay higher prices and face more risk than necessary. Even in the absence of divestiture it would do so because it permits APS to include in rate base two facilities that were constructed by PWEC, Redhawk and West Phoenix, but never judged to be prudent. APS witness Jack Davis testified that if APS could not divest its assets, the Commission should make special provision for these units. Tr. at 125 ("if we're not allowed to divest our assets, we need to address all the assets that were built for reliability of our customers"). Mr. Davis conceded that Redhawk is essentially indistinguishable from the array of merchant facilities also interconnected with, or deliverable to, the Palo Verde switchyard. Tr. at 126 ("certainly RedHawk are large combined cycle units, and they're similar in many ways to other large combined cycle units being built in the Palo Verde area."). Incredibly, APS witness Dr. Cicchetti conceded that these units provide no shareholder value, indicating that they are uneconomic in the marketplace. Tr. at 455. The PPA allows APS to use its existing market power to protect two facilities, owned by its affiliates, which were built as merchant facilities.

## E. <u>COMMISSION JURISDICTION</u>

### 1. After Divestiture, the Commission's Ability to Address Market Power Issues Decreases

Once APS, a regulated public utility, transfers its generation facilities to PWEC, a

federally-regulated wholesale generator, the market power horse has left the barn. Exh. APS-1 at 13 (after divestiture, jurisdiction over PWEC assets will be at FERC, not the Commission). The Commission's ability to combat market power abuses will be substantially lessened, because it will lose some measure of jurisdiction over APS's current generation operations. To a certain extent, market power concerns will then be addressed by the FERC, through market power studies (applying the SMA), the ongoing Standard Market Design rulemaking, RTO development under FERC Order No. 2000, and FERC's general complaint and investigation powers under Sections 205 and 206 of the Federal Power Act.

Nevertheless, to the extent the Commission has authority over currently integrated public utilities, and in this Generic Proceeding it should ensure that market power issues are addressed before allowing divestiture. Staff agrees with this approach. As Staff witness Neil Talbot testified, "Staff certainly believes it would be good public policy to mitigate market power before transfer." Talbot Rebuttal Testimony (Exh. S-7) at 3. The Commission should not limit its remedy to promises to comply in the future, but should ensure that utilities take concrete action in compliance with orders in this proceeding and in Track B before allowing divestiture. Recent history indicates that this course of action is prudent. After all, as recently as 1999, APS promised to competitively procure all of its Standard Offer Service requirements, and now seeks to modify that commitment.

**2. While the Ability to Address Market Power May Be Diminished in the future, the Commission Retains Sufficient Jurisdiction**

Certain parties, including Commission Staff, have expressed concern that upon divestiture the Commission will lose jurisdiction over the wholesale transactions of the formerly regulated generation facilities. Various witnesses testified that the Commission will lose some jurisdiction over the generation assets as they will be engaged in

wholesale transactions governed by the FERC. See, e.g., Davis Direct Testimony (Exh. APS-1) at 13; Talbot Direct Testimony (Exh. S-6) at 23-24. The Commission need not, however, lose jurisdiction over the most important aspect of its mandate: what APS's Standard Offer Service customers pay for APS purchases from its affiliate and other merchant generators for the capacity necessary to supply Standard Offer customers. Through its prudence reviews of the power purchases made by APS, the Commission retains jurisdiction to ensure that consumer benefits flow from competitive procurement whether that be in the form of a merchant, non-affiliated PPA or an Affiliate PPA. Because the Commission certainly has jurisdiction over whether or not APS is entitled to divest its generation assets, the Commission can and should condition any divestiture that jurisdiction on APS's agreeing to a market test prudency standard. In this regard, APS appeared to be attempting through the Track A process to prejudge the issue of what manner of prudence review would be accorded to competitively procured power for affiliate PPAs. The determination of the scope of prudence review, like all competitive procurement rules, is a Track B issue and should not be prejudged to be less than that sufficient to allow the Commission to protect Arizona ratepayers.

Specifically, Panda envisions the Commission maintaining substantial jurisdiction by its control of the competitive procurement process. The Commission will dictate the rules of this procurement and will judge the prudence of the pay-for-performance PPAs that result. Competitor procurement becomes the Commission's tool for determining prudence.

While Panda has argued that the Commission can retain extensive jurisdiction post divestiture through an appropriately structured prudence review, Panda does not agree that this prudence review should be an ongoing review throughout the life of a contract or result in after the fact review of contracts. Rather, the Commission should undertake a heightened review of all competitive results until such time as the

Commission is convinced that the competitive market and APS's affiliate transactions, if any, result in the least cost to consumer. Certainly, the employment of an independent bid evaluator will provide the Commission with a heightened sense of security that the outcome is prudent. Nevertheless, Panda supports heightened Commission review and believes that such review will provide the Commission with sufficient comfort and jurisdiction to protect the interest of Arizona consumers.

### F. Need for Revisions To APS and TEP Code of Conduct

As discussed above, utilities divesting generation assets to an affiliate and subsequently purchasing power from the same affiliate can abuse the affiliate relationship to benefit the non-regulated affiliate at the expense of ratepayers and the market as a whole. Panda agrees with Staff that the existing Code of Conduct and Affiliate Interest Rules do not adequately address problems of self-dealing, preferential treatment of affiliates and cross-subsidization of competitive services. Keene Direct Testimony (Exh. S-11) at 2-3. APS's proposed PPA with its generation affiliate is a case in point – despite a Code of Conduct intended to prevent affiliate abuse, Jack Davis acted as the "final arbiter" of the proposed deal for both the utility and the affiliate. Tr. at 138. All parties appear to believe that Mr. Davis' actions do not violate the existing Code of Conduct or Affiliate Interest Rules. Tr. at 1440.

Panda further agrees with Staff that, before divesting generation or transacting with an affiliate in any way, a UDC should be required to file with the Commission a proposed Code of Conduct that mitigates any potential for conflicts of interest, affiliate abuse, self-dealing or cross-subsidization, and which strictly limits access to commercially sensitive or confidential information. Keene Direct Testimony (Exh. S-11) at 7-8. The Commission should provide interested parties notice and an opportunity to comment on such a proposed Code of Conduct. Further, any aggrieved party should have the opportunity to file a complaint with the Commission if a UDC or any of its

affiliates violates the Code of Conduct.

### G. Commission Jurisdiction In Relation to "For-Profit" and "Not For-Profit" RTOs

During the hearing, Chairman Mundell asked APS witness Jack Davis if "[f]rom a jurisdictional standpoint, meaning the ACC's jurisdiction, is there any distinction between having WestConnect a for-profit or not-for-profit organization?" Tr. at 272. An RTO, whether structured as a not-for-profit independent system operator or a for-profit transmission company, operates and/or owns facilities used for transmission of electric energy in interstate commerce, it is a service squarely within the jurisdiction of FERC under the Federal Power Act. Therefore, operation of an RTO, whether for-profit or not-for-profit, is not currently subject to Commission jurisdiction.

The Commission does have jurisdiction over certain RTO formation issues and over bundled retail rates that contain a transmission component. Again, however, this jurisdiction is based on the Commission's regulation of utilities, not whether a transmission-owning entity is or is not for profit. Although FERC has long proclaimed that it will not favor one form of RTO over another, recent trends appear to disfavor the for-profit transco structure. FERC has rejected all recent transco proposals, and rejected the Alliance RTO proposal for the Midwest, encouraging the Alliance Companies to find a way to accommodate their business plan under the umbrella of the not-for-profit Midwest ISO. Alliance Companies, et al., 97 FERC ¶ 61,327 (2001). One former Alliance member, Dominion Resources, recently announced its intention to join PJM, a not-for-profit ISO. Several states have recently announced their reluctance to approve transfer of transmission facilities by utilities to for-profit RTOs. On March 19, 2002, the Louisiana Public Service Commission found that

> the transfer of ownership or control of transmission assets to a for-profit transmission entity ("Transco") presumptively is not in the public interest; that Louisiana utilities be directed not to join any

> RTO without performing certain analyses; and, that the Staff proceed to analyze congestion management methods and develop, as necessary, ratepayer protection mechanisms to deal with potential adverse consequences of the "financial rights" model for congestion management.

Louisiana Public Service Commission v. Cleco Power LLC, Entergy Gulf States, Inc., Entergy Louisiana, Inc., Southwestern Electric Power Company And Louisiana Generating LLC - In Re: Rule To Show Cause Why Louisiana Transmission Owning Entities Should Not Be Enjoined From Transferring Their Bulk Transmission Assets To A Transco And Related Issues, Order No. U-25965-A (2002) (available at http://www.lpsc.org/OrderU-25965-A(Corrected).pdf).

The Louisiana Commission based its order on a decision of the Louisiana Supreme Court that "recognized that the plenary authority granted to the Commission includes the authority to review transfers of ownership and control of the assets owned by Louisiana utilities." Id. Thus, the Louisiana Commission used its authority over the disposition of utility assets, not authority over transmission services, to dictate the form of an RTO joined by Louisiana utilities. Recently, Entergy Corporation, which had been proposing a for-profit transmission company, joined with Southern Company to propose to FERC a not-for-profit RTO. CLECO Power LLC, et al., Petition for Declaratory Order Concerning the Proposed SeTrans RTO, Docket No. EL02-101-000 (filed June 27, 2002).

The Arizona Commission appears to have similar authority over disposition of utility assets. A.R.S. § 40-285(A) provides that:

> A public service corporation shall not sell, lease, assign, mortgage or otherwise dispose of or encumber the whole or any part of its railroad, line, plant, or system necessary or useful in the performance of its duties to the public, or any franchise or permit or any right thereunder, nor shall such corporation merge such system or any part thereof with any other public service corporation without first having secured from the commission an order authorizing it so to do. Every

> such disposition, encumbrance or merger made other than in accordance with the order of the commission authorizing it is void.

Panda expresses no preference for either a for-profit or a not-for-profit RTO form. The Commission's jurisdiction over Arizona utilities should not, however, be reduced if the utilities join a for-profit RTO instead of a not-for-profit RTO. Indeed, Commission jurisdiction over disposition of utility assets gives the Commission some authority over the form of RTO selected.

## III. CONCLUSION

For the reasons discussed herein, the Commission should permit divestiture of generation facilities to UDC affiliates only if the UDCs adequately implement the competitive procurement process developed in Track B of this proceeding. If the Commission decides not to permit divestiture, it should nevertheless proceed with competitive procurement, which provides ratepayer benefits in addition to mitigating market power resulting from divestiture. In addition, the Commission should require UDCs to propose strong Codes of Conduct that prevent affiliate abuse, cross-subsidization or anti-competitive behavior.

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RESPECTFULLY SUBMITTED this 10th day of July, 2002.

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# VIRGINIA STATE CORPORATION COMMISSION'S ORDERS REGARDING VIRGINIA ELECTRIC AND POWER COMPANY'S RFP

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COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, JANUARY 14, 1999

APPLICATION OF

VIRGINIA ELECTRIC AND
POWER COMPANY

CASE NO. PUE980462

For Approval of Expenditures
for New Generation Facilities
pursuant to Va. Code § 56-234.3 and
for a certificate of public
convenience and necessity pursuant to
Va. Code § 56-265.2

ORDER

On August 11, 1998, Virginia Electric and Power Company ("Virginia Power" or "Company') filed the instant application (the "Application"), requesting regulatory approval for the construction of five new gas-fired turbine generator units of approximately 150 megawatts ("MW") capacity each, to be installed either at a site in Caroline County or a site in Fauquier County. A related application seeks regulatory approval for construction of transmission facilities necessary to connect these generators to the electric transmission grid.

The Application has been twice amended. First, Virginia Power sought to increase the number of units from five to six, and also to utilize both sites. Later, in its rebuttal testimony, the Company modified the request to seek authority to construct only the first four units, using only its site in

Fauquier County. It is proposed that the 4 units would begin operation on or about July 1, 2000.

On September 2, 1998, the Commission Staff ("Staff") moved for a ruling as to whether the Rules Governing the Use of Bidding Programs to Purchase Electricity from Other Power Suppliers, now codified at 20 VAC 5-301-10 ("Rules"), were applicable to Virginia Power's filings. Pursuant to the Commission's order, also issued on September 2, 1998, the Company filed its response to the motion on September 16, 1998, and replies to this response were filed by other interested parties and by the Staff.

Virginia Power's response to the motion stated that it no longer had either an active bidding program or a long term resource plan, and so was not subject to the Rules, but if the Commission found otherwise, requested an exemption from the Rules. The Company asserted that the "critical need in 2000 and 2001 for extensive capacity warrants an exemption" for its Application, and that the Application could not be "accommodated within a competitive bidding process because of the quick timetable." The Company requested the Commission grant an exemption from the Rules "in order to assure the timely availability of this peaking capacity in 2000."

On October 20, 1998, the Commission issued an order establishing a procedural framework within which to resolve the

issues raised by Staff's request for a ruling and the responses filed. The Commission found that an expedited hearing should be convened to determine, "the need for capacity and how any need can best be met, whether the Bidding Rules are applicable and if so whether Virginia Power should be granted an exemption from them, and whether the Virginia Power's asserted 'quick timetable' can accommodate meaningful participation from other parties." To encourage meaningful participation by other potential energy suppliers, the Commission further directed Virginia Power to file, "documents and materials necessary to enable interested parties to determine whether, if there is a need for additional capacity, they can meet such need through construction or purchase of generating capacity, demand side measures, or otherwise." A number of parties did respond to our order of October 20, 1998, by prefiling an intent to bid or testimony indicating their interest in submitting bids for capacity that the Commission may ultimately find to be needed by Virginia Power.[1]

The Commission convened a public hearing on January 5, 1999, which concluded three days later after receiving testimony

[1] Florida Power & Light filed notice of its intent to bid and Verified Declaration. Other parties presenting testimony indicating an interest in submitting bids included Edison Mission Energy, LG&E Power, Dynergy Power Corp., Westmoreland Energy Inc., and Calpine Corporation. Westvaco and the Virginia Independent Power Producers indicated an interest in extending existing power contracts. Additionally, Ingenco, a small scale provider of distributed generation capacity, provided testimony through Public witnesses.

from five witnesses for Virginia Power, eight witnesses from other power producers, a witness for the Attorney General, and two Staff witnesses. The witnesses testifying on behalf of potential bidders gave few specific details on their individual proposals to provide peaking capacity. Thus, the record is unclear as to whether timely bids could be received after the hearing and, if so, whether such bids would be under the benchmark pricing established by Virginia Power's construction proposal. We understand the reluctance of these parties to disclose the competitively sensitive details of their potential bids.

In addition to evidence of potential bids, the prospect for greater market power concentration resulting from Virginia Power constructing the requested gas-fired turbine generator units was also addressed by witnesses for the Attorney General, Staff, Old Dominion Electric Cooperative and the Virginia Independent Power Producers.

We will begin with an analysis of the Rules and the reasons for their promulgation to determine their applicability to Virginia Power today.

The Commission promulgated the Rules by order dated November 29, 1990, in Case No. PUE900029.[2] This case was established because:

> issues relative to the bidding process, including the propriety of an exclusive bidding program and the proper weighting of utility construction compared to purchase options, have arisen in a number of recent certificate and arbitration proceedings filed with this Commission. The growing use of bidding programs and the questions raised in those several proceedings resulted in our determination that it was necessary to initiate this investigation to revisit the principles discussed in the January 1988 Order and to adopt clear rules to delineate a framework for the contracting process between utilities and other power suppliers, both qualifying facilities under PURPA and non-PURPA independent power producers.

The Commission concluded in this order that "bidding programs continue to provide electric utilities with an excellent option for acquiring necessary capacity in an orderly and reasonable manner," and that a utility that establishes such a program "should be free to refuse offers of capacity that have been received outside of its bidding program."[3]

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[2] Commonwealth of Virginia, ex. rel State Corporation Commission, Ex Parte: In the matter of adopting Commission rules for electric capacity bidding programs, 1990 S.C.C. Ann. Rep. 340. The Commission had earlier announced policy guidelines regarding utility capacity bidding programs in Commonwealth of Virginia, ex. rel State Corporation Commission, Ex Parte: In the matter of adopting Commission policy regarding the purchase of electricity by public utilities from qualifying facilities when there is a surplus of power available, Case No. PUE870080, 1988 S.C.C. Ann. Rep. 297, Final Order, January 29, 1988 ("January 1988 Order").

[3] 1990 S.C.C. Ann. Rep. 340. Rule IX codifies this statement.

In the January 1988 Order, the Commission noted it had instituted the proceeding "to consider questions surrounding the acquisition of additional generating capacity by electric utilities." A comprehensive review of this subject was needed "as a result of the contention by one of the state's major utilities, Virginia Power, that it was receiving capacity offers in amounts greater than its projected needs for the foreseeable future."[4]

Both the guidelines and the Rules were intended to impose some structure in utility capacity acquisition at a time when federal law[5] and regulations had caused numbers of new participants to respond to a newly created opportunity to market power to traditional utilities. Prior to the implementation of the Rules, utilities were required to accept capacity offers from qualifying facilities and small power producers whenever they had need for capacity additions and to establish the price for such purchases at the utility's "avoided cost" on a case-by-case basis. Soon, both Virginia Power and this Commission were embroiled in numbers of protracted and contentious negotiations. Hence, the Rules established the important *quid pro quo* that utilities that established bidding programs could refuse offers

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[4] 1988 S.C.C. Ann. Rep. 297.

[5] The Public Utility Regulatory Policies Act of 1978, 16 U.S.C. 2601 et seq., ("PURPA").

received outside the bidding program. With limited exceptions, all capacity acquisition was to be conducted through the utility's bidding program. The bids themselves, compared against the utility's benchmark cost of building the capacity itself, which by rule it must determine, established an acceptable proxy for avoided costs.

In the January 1988 Order, the Commission stated that it "envisions a system in which a utility determining a need for additional power would issue, probably on an annual basis, a form of 'Requests for Proposals,' ("RFP") identifying its requirements in broad general terms, and the factors to be used in selecting projects to meet those needs. Participants in the market would evaluate this RFP in light of their own best interests and respond accordingly." The Commission cautioned utilities to "guard against the temptation to make an RFP overly restrictive in terms of the types of projects which could reasonably meet the threshold requirements. It is important that the process give a fair opportunity to all participants."[6]

It is unquestioned that Virginia Power established and maintained a bidding program. The record is replete with references to various RFPs issued by the Company over the years. At no time has Virginia Power advised the Commission or the

[6] 1988 S.C.C. Ann. Rep. 298 (footnote 3).

interested public that it has abandoned its bidding program, which would re-open its obligation to accept capacity offers. If at any time Virginia Power intends to formally abandon its bidding program, then the Company is directed to file with this Commission its notice of election to do so. Included in such notice shall be a complete description of the Company's methodology for determining its avoided costs under PURPA. This methodology will be in lieu of the use of competitive bids for determining avoided costs.

While Virginia Power has not issued an RFP recently, it requested and received waivers of the Rules as recently as 1996 and 1997.[7] Further, its witness, Mr. Rigsby, testified during the hearing that on the day the Application was filed, August 11, 1998, the utility intended to "go to the market" for at least 264 MW of additional capacity, and would go to the market by issuing an RFP.

The Commission concludes that the Company's contention that it could solicit competitive bids for power without regard for

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[7] Application of Virginia Electric and Power Company, For a Certificate of Public Convenience and Necessity Pursuant to Va. Code § 56-265.2 and Joint Application of Virginia Electric and Power Company, Richmond Power Enterprise, L.P. and Enron Power Marketing, Inc., For authority to enter into a purchased power contract without competitive bidding, Case No. PUE960062, Final Order, November 18, 1996. Application of Virginia Electric and Power Company, Virginia Power SPC-1, Inc., Virginia Power SPC-II, Inc. and Cheasapeake Paper Products Company, For issuance of Certificates of Public Convenience and Necessity Pursuant to Va. Code § 56-265.2 and related regulatory approvals, Case No. PUE950131. The exemption was granted in a 1997 Commission order that was later withdrawn.

or compliance with the Rules is unfounded and untenable. We find that Virginia Power presently has an active bidding program.

It is similarly unreasonable for the Company to contend as it did in its responsive pleading filed September 16, 1998, that it has no long-term resource plan as contemplated by the Rules. Rule III states that any utility's need for capacity identified in an RFP "should be consistent with its long-term resource plans. The capacity need identified by an investor owned electric utility should be consistent with the resource plans filed most recently with the Commission." Virginia Power subsequently acknowledged through its witnesses Cartwright and Green that the capacity need identified in this proceeding is consistent with Virginia Power's most recent long-term resource plans and consistent with its plan "filed most recently with the Commission."

The Rules apply.

We turn now to the request for an exemption from the Rules. We will deny this request. Virginia Power's reason for the exemption is that the Rules cannot accommodate the "quick timetable" for adding the capacity in the year 2000.

In testimony filed with the Application, Virginia Power witness Cartwright asserted that unit construction must begin on the site selected approximately one (1) year in advance of the

planned in-service date for the units. This in-service date is July 1, 2000.[8] Mr. Cartwright, in ore tenus testimony during the hearing disclosed, however, that construction in the form of site preparation should begin by April 1, 1999.[9] While this date was challenged as too early, the procedures that this Order will implement are designed to, and will, accommodate the Company beginning work on the Remington site on April 1, 1999, as proposed.

Concerning the Company's timetable, evidence was brought forward during the hearing that in 1988, while also soliciting bids for peaking capacity, Virginia Power had issued an RFP on November 15, 1988, for capacity with an in-service date of December 31, 1989. Thus, the period from issuance to capacity availability was 13 1/2 months for the 1988 RFP. July 1, 2000, is roughly 18 months from now. No persuasive reason was offered to show that bids for supply of the July 1, 2000, capacity could not reasonably be received and evaluated on a timetable that would accommodate this schedule.

During the hearing, as noted, Virginia Power revealed both that it had finalized the contract for the purchase of the six

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[8] Exh. WRC-6, at 4.

[9] We note, however, that the April 1, 1999, date for beginning site preparation does not appear in the Company's Application or Supplemental Application, nor in its direct, supplemental, additional supplemental, or rebuttal testimonies.

CTs[10] and also that it intends to soon "go to the market" with an RFP. Its last reported intent is to solicit bids for 264 MW of capacity for July 1, 2000, as well as bids for about 850 MW for July 1, 2001, and July 1, 2002. Virginia Power's intent to solicit bids for power delivery on July 1, 2000, indicates its belief that even its "quick timetable" can be accommodated within the Rules for some increment of capacity. We are not persuaded from the evidence that a solicitation for the 600 MW of capacity represented by the units it asks to build cannot also be accommodated. Delivery of both increments of capacity will fall due on the same date.

To the extent that there is time pressure present in this case, the responsibility for such lies squarely with the Company. Further, the record supports and the Rules require that others be permitted an opportunity to supply some or all of the Company's identified peaking capacity requirements.

We are also mindful of the valid concerns over increased market power expressed by Staff, the Attorney General, Old Dominion Electric Cooperative, and others on cross examination. We share their concern that our approval of the proposed construction program will increase the Company's generation market power just when the Commonwealth may undertake to provide

[10] Further, the Company disclosed that it had not finalized its construction contract for installation of the units.

retail customer choice. In light of these market power concerns, we believe it appropriate for this Commission to encourage new entrants into Virginia's electricity market.

Therefore, we will order the Company to issue an RFP for at least the entire increment of capacity needed by July 1, 2000, and we direct our Staff to oversee the immediate development of the RFP and to review the Company's evaluation of all responses to it. The Staff is also directed to report any irregularities or complaints about the procedures promptly to the Commission for our further consideration. At the hearing, the Company indicated that its RFP would be ready in a matter of days. Accordingly, the Company should, no later than January 19, 1999, at noon, deliver to the Staff its proposed RFP and the Staff will promptly review and amend the proposal, as it deems appropriate.

Thereafter, Virginia Power will disseminate the RFP approved by Staff broadly within the interested marketplace by publication in appropriate newspapers and trade journals, by distribution via the Internet, and by direct delivery of the RFP to the Virginia Independent Power Producers ("VIPP") and other parties in this case, to parties that have previously entered into purchased power contracts with Virginia Power, to surrounding utilities, and to other organizations of potential suppliers. Responses for the capacity need identified for

July 1, 2000, will be received and considered on an expedited schedule set out below, while the solicitation process for the 2001 and 2002 capacity may occur at a more measured pace. The Company is, however, free to include the 2001 and 2002 capacity requirements within the RFP to be issued in conformance to this order, with notification that the scheduling of responses and evaluation of these bids will be issued separately.

We again caution Virginia Power, as we did in our January 1988 Order, to "guard against the temptation to make an RFP overly restrictive in terms of the types of projects which could reasonably meet the threshold requirements. It is important that the process give a fair opportunity to all participants."[11] We direct the Company to consider any and all options that might reliably meet the identified need, including those that would utilize power wheeled into Virginia Power's service territory making use of the Company's available transmission capability as identified during the hearing.

The RFP shall clearly state preferences for purchased power arrangements such as the nature, operating characteristics and location of capacity. The Company may also include appropriate provisions for discouraging frivolous bids and for requiring surety for contracting parties. The Company should consider

[11] 1988 S.C.C. Ann. Rep. 298 (footnote 3).

bids for offers of up to 30 months, for offers to meet the July 1, 2000, need. Provisions for extending such arrangements should also be considered by the Company.

The Company shall compare any offers so received against the benchmark cost of its proposed units as set out in its Application as amended. We agree with Virginia Power that non-price factors should be weighed less heavily than in earlier solicitations. However, we believe that reliability is an appropriate non-price factor for consideration. For example, "iron in the ground" within the Company's control area should be viewed as being more reliable than a proposal for firm energy from an unspecified source. Consistent with the market power concerns raised by the Staff and other parties, mitigation of Virginia Power's market power is another non-price factor for consideration. We will grant an exemption from consideration of additional non-price factors, to the extent such consideration is mandated by the Rules.

We further agree with the Company that, since the RFP to be ordered herein may generate a wide variety of offers, it should be exempted from the Rules' requirement of issuing a form purchase contract together with the RFP.

If the Company's build option is the successful bid (and its testimony indicates strong confidence that it will be), Virginia Power will be required to install the capacity at a

capped price not to exceed the amount set out in its testimony and Application. This "price cap" is needed to ensure that the Company's and any potential bidder's financial risks are comparable.

Virginia Power's witnesses all expressed strong belief that the market will unlikely be able to supply the entire increment of July 1, 2000, capacity at prices below the build option. The witness for the Old Dominion Electric Cooperative, Mr. Kappatos, voiced a similar opinion, as did the Staff. If, as is believed by these entities, this is the case, then evaluation of any responses to the RFP for the July 1, 2000, block of capacity should not be difficult. However, the Commission finds that the Rules, and sound policy, dictate that the market be provided the opportunity to express itself through the bidding process.

The Commission also finds that the Company's contention that there is a critical need for additional capacity in the summer of 2000 is well-founded. In order to meet this need, the Commission will, pursuant to § 56-234.3 of the Code of Virginia, conditionally grant the Company the authority to make financial expenditures for the proposed units at its Remington site in Fauquier County. Virginia Power is authorized and directed to begin such necessary permitting and site preparation work as needed to ensure the timely installation of the proposed combustion turbines. The Company is to continue such activity

during the pendency of the bidding process, at its expense and risk, until such time as the Commission orders differently. The Company is further directed to maintain its ownership of the combustion turbines while this action remains pending. The authorization granted herein is conditioned upon the bidding process uncovering no superior bid or bids for the supply of the needed capacity.

The Commission directs its Staff to review offers for capacity for July 1, 2000, and to report to the Commission as set out below the results of its review of the Company's evaluation of said offers. If no superior bids are received, the Commission will issue to Virginia Power certificates of public convenience and necessity by further order, which may impose additional conditions relative to the Company's use of the units.

Should reliable suppliers willing to meet the capacity needs at lower prices come forward, the Commission will issue a further procedural schedule. We expect and direct Virginia Power, however, to begin immediate negotiation to finalize an agreement with any such supplier who comes forward in response to the solicitation and offers to meet any portion of the identified capacity need at a superior price. Such negotiations, if any, over final contract details need not await the establishment of the further procedures contemplated herein.

Accordingly, IT IS ORDERED THAT:

(1) Virginia Power shall, no later than January 19, 1999, at noon, deliver to the Commission Staff its proposed Request for Proposals ("RFP");

(2) Staff shall review and, if necessary amend, the RFP and return the document to Virginia Power on or before January 21, 1999;

(3) Virginia Power shall immediately cause the RFP approved by Staff to be published and distributed as discussed herein;

(4) Interested parties shall submit to the Company, and may submit to the Commission's Division of Energy Regulation, responses to the solicitation for the July 1, 2000, capacity on or before March 26, 1999;

(5) Staff shall file with the Clerk of the Commission on or before April 2, 1999, a preliminary report detailing whether it appears that any responses so received indicate supplier or suppliers willing and able reliably to meet the need at prices below the Company's build option, and if so, how much further analysis of such offer or offers is required;

(6) To the extent that the requirements of this Order do not comply with the Rules, appropriate exemption therefrom is granted;

(7) The financial expenditures of Virginia Power proposed herein are approved, conditioned as set forth herein, pursuant to Code of Virginia § 56-234.3; and

(8) This matter is continued for further order of the Commission.