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BEFORE THE ARIZONA CORPORATION COMMISSION

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

Docket No. E-00000A-02-0051

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

Docket No. E-01345A-01-0822

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

Docket No. E-00000A-01-0630

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

Docket No. E-01933A-02-0069

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

Docket No. E-01933A-98-0471

Arizona Corporation Commission  
**DOCKETED**

JUL 10 2002

**RUCO'S CLOSING BRIEF**

DOCKETED BY *CAK*

**INTRODUCTION**

Electricity deregulation is in trouble. Electricity wholesale markets in the western United States are dysfunctional and remain under federal price-cap controls. Competition has not materialized for Arizona's small retail consumers; nevertheless, retail customers will eventually have to pay for the costs of the "transition" to a competitive regime that appears less and less

1 likely. The Commission's Staff explained the problem in a single sentence: "In summary, there  
2 are very few states that can clearly demonstrate benefits from retail competition to date – and  
3 very few small customers have seen significant, lasting benefits." (Staff Report in the Generic  
4 Electric Restructuring Docket, E-00000A-02-0051 (March 22, 2002), p. 11.) In light of these  
5 circumstances, the Commission has taken a second look to determine whether and how to  
6 proceed with electric restructuring.

### 7 **VACATE DIVESTITURE REQUIREMENT DUE TO MARKET POWER**

8 Dysfunctional electricity markets, such as California's from 2000-2001, have the  
9 potential to severely harm the public within a very short period of time. Fortunately, retail price  
10 caps in the APS and TEP service areas have insulated those Arizona consumers from  
11 California-style disruption. However, Arizona customers may not be protected in the future,  
12 especially when APS's price caps cease in 2004.

13 Arizona's wholesale electricity markets lack a sufficient track record and transparency to  
14 ensure that consumers will be safe if the retail rate caps are lifted and retail prices become  
15 more directly influenced by wholesale markets designed by the Federal Energy Regulatory  
16 Commission ("FERC"). More information is needed to properly assess potential market power  
17 in the Arizona electricity market. (Tr. 1012, line 7 to 1017, line 20 (Rosen).) RUCO witness  
18 Rosen listed several factors that affect market power, such as market structure, plant  
19 ownership, the plant's position on the supply curve and its variable costs of production and  
20 dispatch characteristics. (Tr. 1010, lines 11-20.) Other characteristics of the electricity system  
21 will be relevant. *Id.*

22 Lacking the hard data to fill the transparency void, proponents of the current regime  
23 substitute linguistic stratagems and invoke belief systems to make their case. These  
24 proponents berate witnesses who see deficiencies in the current structure as not having

1 sufficient belief in a metaphorical "free market" or "free enterprise." For example, Panda's  
2 counsel, attacked RUCO's witness Rosen with the following complaint: "what I hear you saying  
3 is that regulation beats free enterprise in electricity and telecom." (Tr. 1038, lines 1-3.) One  
4 should not be so surprised that the truth-seeking process yields unfamiliar ideas.

5         Some proponents want the Commission to "let the market tell us" what to do. This is  
6 no time for the Commission to let its guard down. Electricity restructuring has proven to be  
7 tricky and full of surprises. (Tr. 1026, line 18 - 1028, line 19; 1036, line 7 - 1037, line 24  
8 (Rosen).) As RUCO witness Rosen testified, events of the past 6 months have revealed that  
9 the independent power business might be more speculative and less creditworthy than  
10 previously believed. (Tr. 1029, line 13 to 1031, line 6.) The Commission must not sacrifice the  
11 long-run interests of ratepayers if competitive prices are attractive only in the short run. (Tr.  
12 1024, line 4 - 1025, line 7; 1028, line 20 - 1031, line 6 (Rosen).) The task at hand is to analyze  
13 the potential outcomes of different market power conditions. (Tr. 1031, line 7 - 1032, line 6  
14 (Rosen).) The Commission's motto should be "show me the benefits" of the new market  
15 structure. Learn as much as possible from others' mistakes, particularly the FERC's.

16         The proponents support their arguments with market study methodologies that address  
17 a piece of the problem, the approximately eight hours of the year that require reserve must-run  
18 ("RMR") generation. (Tr. 1048, line 1 - 1051, line 14 (Rosen); 1094, line 1 - 1095, line 9  
19 (Deise).) The studies ignore the other 8752 of the hours in the year in which consumers could  
20 be exposed to market-rigged pricing. *Id.* These studies do not thoughtfully evaluate the  
21 incentives and potential consequences of a proposed market structure. (Tr. 941, line 16 - 943,  
22 line 5 (Hieronymus).) They do not fill the transparency void. They are junk science. (See Tr.  
23 1049, line 18 - 1050, line 4 (Rosen).)

24

1           Some testimony suggests that the Commission is in a "transition period" in which  
2 electricity regulation eventually becomes the responsibility of the Federal Government. Staff  
3 witness Talbot described it as follows:

4  
5 [I]t seems appropriate at some point for the Commission to make a determination that it is  
6 happy to place confidence in FERC and the market as regulated by FERC and as monitored  
7 by an RTO ... at which time the Commission can have reasonable confidence that market  
8 purchases competitively procured by a UDC will be at just and reasonable prices.

9  
10 (Tr. 1301, line 25 - 1302, line 7.) Mr. Talbot believes Congress will properly motivate the  
11 FERC to "do a good job." (Tr. 1305, lines 1-17.)

12  
13           This gets to a key issue: whether FERC will be able to solve the problems presented so  
14 far, as well as any new difficulties we might face in the future. This issue arises because  
15 FERC will have market base rate authority over generation that APS divests without a  
16 purchase power agreement. (Tr. 470, line 3 - 473, line 20 (Cicchetti).) Evaluating FERC's  
17 potential impact necessarily requires guesswork and assumption; witnesses on this issue  
18 typically break down into those who are optimistic and those who are less optimistic about  
19 FERC's abilities. (See, e.g., Tr. 1161, line 18 - 1162, line 11 (Peterson); Tr. 1176, line 15 -  
20 1177, line 20 (Higgins); Tr. 1320, line 1 - 1321, line 4 (Talbot).)

21           The United States General Accounting Office ("GAO") says that FERC has "continued  
22 to struggle to define the specific strategies, processes, and activities that it will use to regulate  
23 and oversee the emerging energy markets." (Mundell Ex. A, p. 7. See also, Tr. 1044, line 2 -  
24

1 1045, line 6 (Rosen.) FERC also may not have the legislative framework and legal authority  
2 to properly handle competitive markets. *Id.*

3 FERC's track record suggests that the agency still is struggling to define how to  
4 structure markets. (Tr. 458, line 6 - 464, line 12 (Cicchetti).) As Staff witness Talbot testified,  
5 during the California Energy Crisis of 2000-2001 FERC "may have been bound up with some  
6 inappropriate ideas; for example, its unwillingness to act in the California situation for a period  
7 of time." (Tr. 1309, lines 2-5 (Talbot); Tr. 307, line 11 - 308, line 1 (Cicchetti).) The historical  
8 record suggests that FERC has not come to grips with its new pricing scheme.

9 FERC began investigating the California wholesale power markets in August 2000. 92  
10 FERC ¶ 61,172. On December 15, 2000 FERC terminated the California power exchange's  
11 authority to operate as a mandatory exchange and prohibited the California investor-owned  
12 utilities ("IOU's") from buying or selling power in the exchange. 93 FERC ¶ 61,294. The FERC  
13 took this step notwithstanding regulations of the California Public Utilities Commission that  
14 required the IOU's to buy and sell power in the exchange.

15 By January 2001, at least one commentator suggested that the price spikes were not  
16 attributable solely to supply problems, high demand and higher natural gas prices.  
17 McCullough, *Price Spike Tsunami: How Market Power Soaked California*, Public Utilities  
18 Fortnightly 1 Jan. 2001: 22. Empirical data showed that power supplies and weather  
19 conditions in 2000 were not materially different from 1998 or 1999, when prices were much  
20 less volatile. *Id.* at 24-25. This meant that the California Commission would have difficulty  
21 granting rate increases without knowing whether the increases would be indirectly funding anti-  
22 competitive behavior by power generators.

23 FERC did not effectively act to mitigate the western power spot markets until June 19,  
24 2001. 97 FERC ¶ 61,418. Nevertheless, FERC refused to mitigate market power in the

1 western bilateral contracts markets. (Tr. 1083, line 24 to 1085, line 1 (Rosen).) The June 19  
2 order is set to expire on September 30, 2002. In the meantime, FERC has attempted to craft a  
3 long-term solution in developing a Standard Market Design. (Peterson Direct, pg. 9, lines 4-  
4 7). The details of that initiative suggest that FERC does not have sufficient expertise to  
5 properly ensure that markets will be workable competitive. (Tr. 371, lines 2-19 (Cicchetti).)

6 In Arizona, the current plan is for APS to divest generation to an affiliate, Pinnacle West  
7 Capital Corporation ("PWCC"). If the divestiture occurs without a very tight, loophole-free  
8 purchase power agreement, then PWCC and other market generators will have sufficient  
9 market power to charge excessive prices. (Tr. 926, line 10 - 929, line 20; 931, line 20 - 933,  
10 line 5 (Hieronymus); Tr. 1009, line 7 - 1010, line 20 (Rosen); Tr. 1177, lines 13-23 (Higgins).)  
11 See also, Tr. 309, line 19 - 310, line 16; 451, line 18 - 452, line 19 (Cicchetti). Such market  
12 power undermines the transparency of the electricity markets and the success of electricity  
13 restructuring. (Tr. 310, line 6 - 311, line 22; 340, line 15 - 345, line 14 (Cicchetti).)

14 Because FERC cannot be counted on to mitigate the Arizona power market in timely  
15 fashion, the Commission should vacate the requirement that APS divest generation pursuant  
16 to A.A.C. R14-2-1615. The Commission should reconsider divestiture only when it is  
17 convinced that FERC can adequately protect consumers from market power pricing.

#### 18 IF PROCEED TO DIVEST, ADOPT SOME SORT OF PPA

19 If the Commission decides to proceed with divestiture now, standard-offer customers  
20 should be given access to the cost-based rates of a utility-owned generator. (Rosen Direct,  
21 pg. 2, lines 7-12; Tr. 385, line 2 - 386, line 25; 407, lines 2-14 (Cicchetti).) These resources  
22 are likely to be lower cost than the market prices that independent power producers will charge  
23 to recover their higher cost of capital. (Tr. 343, line 7 - 345, line 14 (Cicchetti); Tr. 1006, line  
24 18 - 1007, line 21; 1008, line 3 - 1009, line 10 (Rosen).) A starting point for this strategy is the

1 proposed APS purchase power agreement, which would protect ratepayers from market power  
2 pricing and the political disruptions that such actions would generate. (Tr. 1075, lines 5-15  
3 (Rosen); Tr. 309, line 19 - 310, line 16; 340, line 15 - 345, line 14 (Cicchetti).)

4 If APS must purchase power through competitive bidding, least-cost principles should  
5 govern the evaluation process. (Tr. 1075, line 16 - 1076, line 6 (Rosen).) The bidding process  
6 should compare and contrast all options for meeting Arizona's native load power needs,  
7 including the construction of utility-owned resources and demand-reduction incentives. (Tr.  
8 1036, line 24 - 1037, line 24 (Rosen); 1103, line 6 - 1105, line 1 (Deise); 467, lines 1-7  
9 (Cicchetti).) Options should be selected for the optimal (i.e., least cost) configuration of  
10 transmission and generation infrastructure to meet Arizona's power needs.

#### 11 **IF NO PPA, DELAY DIVESTITURE AT LEAST A YEAR**

12 Nearly every party to this proceeding agrees that the Commission should be concerned  
13 about market power. As discussed above, FERC appears to be unable to effectively address  
14 wholesale market power issues at this time. Therefore, if the Commission desires to proceed  
15 with divestiture, but is unwilling to consider a purchased power agreement for acquisition of  
16 most standard offer power, the Commission should delay divestiture at least a year to permit  
17 adequate time to study the complex issues of market power, transmission and bidding  
18 processes. RUCO would recommend that a technical advisory committee be established to  
19 conduct a comprehensive market power study, based on strategic behavior modeling.

20 FERC's newly-proposed SMA test is an inadequate test for market power. Panda's  
21 witness Roach outlined a number of inadequacies of the SMA test. (Roach Direct, pg. 8, line 1  
22 - pg. 11, line 5.) Even APS's witness Hieronymus acknowledged a shortcoming of the test, in  
23 that it treats all capacity as available to compete in a competitive wholesale market even if that  
24 capacity is already associated with serving native load. (Tr. 942, line 17 - 943, line 5.) The

1 SMA test is intended to screen for only those suppliers who hold the most insidious form of  
2 market power, when the market is an absolute price taker in relation to a single supplier.  
3 However, the absence of absolute pricing power during periods of high demand does not  
4 mean that market power does not exist during other periods. (Rosen Direct, Exh. RAR-2, pgs  
5 37-38.)

6 Likewise, California ISO's Residual Supply Index ("RSI") (proposed by AECC witness  
7 Higgins) is an inadequate test to determine the potential for the exercise of market power in  
8 Arizona's wholesale power market. This screen is better than FERC's proposed SMA screen  
9 because it does require the analyst to calculate the index for each hour, though the FERC  
10 SMA screen could be applied in each hour also. However, the RSI does not incorporate  
11 sufficient detail regarding the structure of the market to be very useful. For example, as with  
12 the SMA screen, it does not incorporate ownership concentration, it does not include  
13 information on the shape of the cost-of-supply curve, it does not include information on the  
14 demand curve, it does not include information on what kind of power plants and power  
15 contracts are controlled by each generation owner, it does not include information on  
16 transmission constraints, etc. Thus, the RSI screen is fundamentally no better than the SMA  
17 screen. It is only a very rough screen, not a precise analytical tool for measuring the potential  
18 for market power. Whether the screen is "passed" or not is simply a "yes/no" answer. These  
19 screens provide no indications, given the structure of the market, as to "how much" market  
20 power might be exercised. (Rosen Rebuttal, pg. 11, line 7 – pg. 12, line 7.)

21 Staff has proposed that utilities be required to file a market power study and mitigation  
22 plan for approval prior to transferring any generation assets to an affiliate. (Rowell Direct, pg.  
23 10.) RUCO agrees that market power should be studied prior to divestiture, and further  
24 suggests that the market power study should be comprehensive, covering the entire Arizona

1 wholesale power market. In addition, the study should be performed on a cooperative basis  
2 with input from all parties through the creation of a technical advisory committee. Strategic  
3 behavior modeling is essential to properly assess the potential for market power. (Rosen  
4 Direct, pg. 13, lines 3-20; Rosen Rebuttal, pg. 11, lines 3-6; Rosen Rebuttal Exh. 3, pg. 19;  
5 Schlissel Direct, pg. 12, lines 14-17.)

#### 6 **FURTHER STUDY HAS COSTS TO CUSTOMERS**

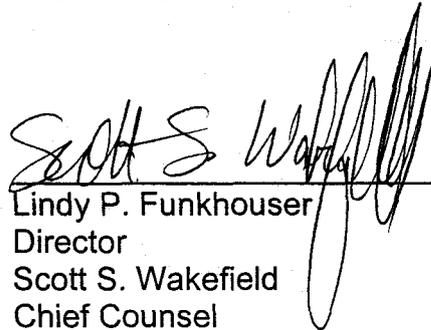
7 If the Commission determines that further study of electric restructuring is necessary, it  
8 should not lose sight of the fact that such studying results in costs to consumers. In approving  
9 APS's stranded cost settlement, the Commission authorized APS to recover the reasonable  
10 and prudent costs of compliance with the Electric Competition Rules (with the exception of  
11 APS's costs of transferring its generation assets to an affiliate, which were limited to 67% of  
12 such costs) through an adjuster mechanism to commence on July 1, 2004. (Decision No.  
13 61973, pg. 10, lines 7-8 and Attachment 1, Section 2.6(3)). Therefore, APS is currently  
14 creating an ever-growing liability to ratepayers for the cost of restructuring the industry. If the  
15 Commission questions the desirability of electric competition, APS should not be permitted to  
16 accrue an ever-mounting liability for the cost of transitioning to competition. If the Commission  
17 is reluctant to rescind its accounting order authorizing the deferral of transition expenses, it  
18 could, at a minimum, add conditions to the order to protect customers. (Diaz Cortez Rebuttal,  
19 pgs. 6-8.)

#### 20 **CONCLUSION**

21 Until the Commission is assured that FERC is adequately overseeing Arizona's  
22 wholesale electric market, the Commission should suspend its divestiture requirement. When  
23 the Commission is confident that the wholesale market is workable and free of market power  
24

1 pricing, divestiture should be accompanied by purchase power agreements that insure that  
2 standard offer customers have access to electricity at cost-based prices. In the event the  
3 Commission determines that divestiture can proceed without a purchase power agreement in  
4 place, it should delay divestiture for at least a year to conduct further study, including strategic  
5 behavior modeling, to accurately assess market power concerns. Finally, whatever course the  
6 Commission takes at this time, it should not overlook the fact that customers will ultimately be  
7 asked to pay for the costs of the transition to restructured markets. If the Commission cannot  
8 assure customers that continued analysis is cost-beneficial, it should cease further efforts at  
9 this time.

10 RESPECTFULLY SUBMITTED this 10th day of July, 2002.

11  
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14 Lindy P. Funkhouser  
15 Director  
16 Scott S. Wakefield  
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