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Arizona Corporation Commission
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Re: Docket Nos. E-00000A-02-0051, E-01345A-01-0822; E-00000A-01-0630; E-01933A-02-0069
In the matter of the Consolidated Generic Proceedings Concerning Electric Restructuring, et al

Dear Ms. Ryan:

Enclosed for filing in the above-captioned proceeding are the original and nineteen (19) copies of the Sempra Energy Resources and Southwestern Power Group, II Initial Brief on Track "B" Issues. Also enclosed are two additional copies to be conformed and returned to our office.

Please let me know if you have any questions, and thank you for your assistance.

Sincerely,

Lawrence V. Robertson, Jr. / JM
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BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
CHAIRMAN
JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER

IN THE MATTER OF THE GENERIC) Docket No. E-00000A-02-0051
PROCEEDINGS CONCERNING ELECTRIC)
RESTRUCTURING ISSUES)
)
IN THE MATTER OF ARIZONA PUBLIC) Docket No. E-01345A-01-0822
SERVICE COMPANY'S REQUEST FOR A)
VARIANCE OF CERTAIN REQUIREMENTS OF)
A.A.C. R14-22-1606)
)
IN THE MATTER OF THE GENERIC) Docket No. E-00000A-01-0630
PROCEEDING CONCERNING THE ARIZONA)
INDEPENDENT SCHEDULING)
ADMINISTRATOR)
)
IN THE MATTER OF TUCSON ELECTRIC) Docket No. E-01933A-02-0069
POWER COMPANY'S APPLICATION FOR A)
VARIANCE OF CERTAIN ELECTRIC) **INITIAL BRIEF ON TRACK "B"**
COMPETITION RULES COMPLIANCE DATES) **ISSUES**
)
_____)

Pursuant to the briefing schedule established in the above-captioned consolidated proceedings, Sempra Energy Resources and Southwestern Power Group II ("Sempra/ SWPG") hereby submit their Initial Brief on those Track "B" issues they desire to address in their Initial Brief. Depending upon the matters raised and arguments advanced by other parties in their respective Initial Briefs, Sempra/ SWPG may have occasion to address additional issues in their Reply Brief.

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I.

**STATEMENT OF GENERAL SUPPORT FOR COMPETITIVE
PROCUREMENT PROCESS SET FORTH IN STAFF'S
OCTOBER 25, 2002 REPORT ON TRACK B: COMPETITIVE
SOLICITATION ("STAFF REPORT")**

A. Introduction

Sempra/ SWPG wish to commend the Commission's Staff and its consultant for their efforts in conducting the several workshops which have occurred in the Track "B" phase of the above-captioned consolidated proceedings, and in distilling the results of those workshops in the Staff Report. Through the collaborative effort facilitated by the Staff and its consultant, the parties have been able to reach consensus on a substantial number of matters. Certain issues still remain, and the manner of resolution of these will bear importantly upon the success of the competitive procurement process ultimately adopted by the Commission. But the Staff's contribution has been commendable and warrants recognition at this juncture.

As a consequence, Sempra/ SWPG find themselves in a position where they are generally supportive of the recommended competitive procurement process set forth in the Staff Report. They do differ with the Staff's recommendations in certain respects, and their suggested alternatives are discussed below at various points in this Initial Brief.

B. Specific Support for Staff's Process Goals.

Sempra / SWPG strongly support the competitive procurement process goals which are set forth in the Staff Report, and were subsequently endorsed during the Staff witness panel testimony. As therein indicated, the process to be selected by the Commission should be (i) transparent, with resulting cost savings for ratepayers, (ii) equitable and auditable, (iii) well developed yet flexible,

1 and (iv) understood by all participants [Ex. S-1, page 1]. Further, the process should provide an
2 opportunity for all qualified prospective participants to compete on equal and unbiased terms; and
3 it should encourage the development of an ongoing and viable competitive wholesale power market
4 benefiting electric consumers [Ex. S-1, page 1]. Finally, although experience acquired during the
5 initial solicitation may lead to certain refinements and changes in subsequent competitive
6 solicitations, the aforementioned process goals should be applicable to and characterize all present
7 and future competitive power procurement occurring in Arizona. [Ex. S-1, page 27, lines 8-13; Tr.
8 71, line 13 - Tr. 72, line 8] In that regard, Sempra/ SWPG recommend that the Commission
9 expressly indicate in its decision that all future competitive solicitations will be conducted with the
10 same openness and opportunity to participate as have characterized the current Track "B"
11 proceeding. Merchant plant competitors and other interested persons who were not in a position to
12 participate in the initial solicitation in 2003 should not be precluded from participation in subsequent
13 competitive procurements.
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17 **C. Intent to Review and Amend Process as Necessary**

18 The Staff has indicated it intends to review the initial competitive procurement process
19 adopted by the Commission after the same has been implemented; and, based upon experience with
20 and the results of that process, to perhaps suggest refinements and amendments for future
21 solicitations. The stated purpose in doing so is to reflect lessons learned regarding the effectiveness
22 of the initial procurement in achieving the aforementioned process goals, and to improve the process
23 itself. [Ex. S-1, page 27]. Sempra/ SWPG are supportive of the Staff's approach in this regard.
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D. Utility Decision Making and Subsequent Prudency Review

Sempra/ SWPG also generally agree with the balance that the Staff has endeavored to strike between (i) allowing the utility to conduct the competitive solicitation and make the final bid selections, and (ii) providing for continuing Commission oversight and subsequent prudency review. Inasmuch as it is the utility which must implement and live with the results of a given power procurement decision, it is appropriate that it perform a significant role in the making of such decision. At the same time, the utility should be held accountable for the results of its decision and its compliance or lack of compliance with the Commission - approved competitive procurement process. The contemplated subsequent prudency review is the setting in which such accountability will be determined, and appropriately so.

E. The Desired Result

As the Commission indicated in Decision No. 65154 in Track "A" of these consolidated proceedings, Track "B" is intended to establish that procurement process through which the development of a viable and ongoing competitive wholesale power market in Arizona can be facilitated. [Decision No. 65154 at page 23, lines 15-18] In furtherance of that objective, Sempra/ SWPG believe that the Commission should adopt a competitive procurement process which (i) allows for consideration of all types of competitive solicitations and proposals, (ii) requires sound economic and deliverability analysis of bids, and (iii) is not biased by its nature and design towards any predetermined outcome.¹ A process of this nature would (i) incorporate most of the features of

¹ In this regard, as indicated in Section III below of this Initial Brief, it is Sempra/SWPG's view that the short-term type of power procurement strategy advocated by Arizona Public Service Company ("APS") should be rejected by the Commission, inasmuch as it is incompatible with these principles and fraught with other potential problems.

1 the proposed competitive procurement process set forth in the Staff Report, (ii) satisfy the process
2 goals of the Staff discussed above, and (iii) be conducive toward realization of the Commission's
3 aforementioned desired result.
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5 **II.**

6 **IMPLEMENTATION OF STAFF'S PROPOSED**
7 **COMPETITIVE SOLICITATION PROCESS**

8 **A. Determination of "Unmet Needs"**

9 1. Staff's Interpretation of Decision No. 65154 is Correct

10 In Decision No. 65154, the Commission stated as follows in describing the intended purpose
11 and scope of the Track "B" proceedings:
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13 "... effective upon implementation of the outcome of Track B, we
14 will require APS and TEP to acquire, at a minimum, any required
15 power that cannot be produced from its own existing assets, through
16 the competitive procurement process as developed in the Track B
17 proceeding. The amount of power, the timing, and the form of
18 procurement shall be determined in the Track B proceeding."
19 [Decision No. 65154 at page 30, lines 9-12]

20 In the Staff Report, as amended at the Track "B" hearings, the Staff described its understanding of
21 the Commission's aforesaid directive in the following manner:
22

23 "To the extent that a utility has load requirements, capacity or energy,
24 not economically served by generating capacity owned by the utility
25 or through existing contracts for capacity or energy or from which the
26 utility must purchase power as a result of law or regulation, that
27 unmet need will be acquired through a competitive solicitation." [Ex.
28 S-1, page 4, line 20; also, see Ex. S-1, page 7, line 5 and page 35, line
5; and Ex. S- 3, page 12, lines 1-2] [emphasis supplied]

1 The aforementioned amendment was the Staff's addition of the word "economically" to the above-
2 quoted text of the Staff Report. During its cross-examination of the Staff witness panel, APS
3 challenged the Staff's attribution of this qualifying word to the Commission's intent in issuing
4 Decision No. 65154, and the accuracy of that interpretation thus became an issue.
5

6 The Staff's conclusion that the Commission intended the phrase "required power" in
7 Decision No. 65154 to include capacity and energy requirements a utility cannot "economically"
8 serve with its own generation resources is correct. This is the only construction that is
9 philosophically and logically consistent with the Commission's often stated objective of providing
10 ratepayers with reliable power at the lowest possible cost. In fact, it is the only construction that is
11 reconcilable with the Commission's expressly stated desire to insure "just and reasonable rates for
12 captive [utility] customers." [Decision No. 65154 at page 29, lines 7.5-8.5] Otherwise, such
13 customers are at the mercy of the utility's unfettered exercise of its discretion, and such exercise
14 would not be subject to that prudence review associated with the competitive procurement access.
15 Furthermore, it is no answer to suggest that reliability can be provided only through utilization of
16 utility-owned generation, as some may contend. The use of comprehensive bid evaluation criteria
17 as part of the competitive solicitation process will ensure that the reliability criterion is satisfied.
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21 2. Staff's Approach Maximizes A Utility's Knowledge of Alternatives

22 A stated purpose of the Staff's proposed competitive procurement solicitation process is to
23 maximize the utility's knowledge of different ways in which its capacity and energy requirements
24 may be economically and reliably served. [Tr. 189, lines 4-11] Sempra/SWPG believe that the Staff's
25 proposal can achieve this objective, particularly if modified in the manner discussed below in
26 Section II(B) of this Initial Brief to allow more time for the utility to evaluate competitive proposals
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1 as to price and deliverability using a system integration analysis. In addition, they believe the diverse
2 types of information received under the Staff's approach will enhance the prospects for a successful
3 solicitation.
4

5 3. Inclusion of RMR Requirements Is Appropriate

6 The Staff has proposed that the RMR requirements of APS and Tucson Electric Power
7 Company ("TEP") should be included as a part of each utility's "contestable load" which will be
8 subject to the initial competitive procurement. [Ex. S-5] Sempra/ SWPG believe that such inclusion
9 is appropriate for several reasons. First, as previously noted, a purpose of the proposed solicitation
10 process is to maximize a utility's knowledge of different ways in which its capacity and energy
11 requirements may be economically and reliably satisfied. If a utility looks only to its own resources,
12 it will not have a complete picture of the choices and related costs available to it. Second, under the
13 proposed procurement process, the utility retains the discretion to make the final decision as to the
14 means whereby its needs will be served. Thus, it is in a position to be sure any concerns it may have
15 as to price and reliability, including deliverability, are addressed. All the Staff's proposal requires
16 is that the utility solicit and consider alternatives, and be prepared to justify its ultimate selections.
17 In that regard, Sempra/ SWPG suggest that the Commission consider the possibility of continuing
18 to allow, for a brief transition period, a rate of return on the undepreciated value of a utility's RMR
19 generation assets displaced by non-affiliate competitive power.² Both a precedent and an analogy
20 for such a regulatory approach may perhaps be found in that portion of the Commission's retail
21 electric competition rules relating to the recovery of "stranded costs."
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27 ² Footnote 8 in Decision No. 65154 (page 23) alludes to the possibility of a utility decision to
28 displace an "inefficient, uneconomic or environmentally undesirable plant," but provides no insight
as to the possible future ratemaking consequences of such action.

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2 4. Proposed Exclusion of Power Purchased Under Future QF Contracts from "Contestable
3 Load" is appropriate

4 The Staff Report recommends that power purchased under future contracts with QF facilities
5 be excluded from a utility's "contestable load." [Ex. S-1, page 31, line 16, and page 35, lines 6-7]
6 Sempra/ SWPG believe that the exemption of such power supply arrangements from competitive
7 solicitation is appropriate for two related reasons. First, it is consistent with the requirements of the
8 Public Utility Regulatory Policies Acts ("PURPA") and related regulations promulgated by the
9 Federal Energy Regulatory Commission. Second, it is consistent with the Commission's previously
10 expressed intent not to contravene through its own decisions and regulations any power procurement
11 obligations a utility might have under Federal law or regulation.

12
13 **B. Recommended Modifications to Staff's Proposed Solicitation Timeline For Requests**
14 **For Proposal.**

15 During the Track "B" hearings, Sempra witness Douglas Mitchell recommended that certain
16 bid evaluation activities should be undertaken by a utility as a part of the competitive solicitation
17 process. [Ex. Sempra -1, page 6, lines 1 - 20] More specifically, he recommended that the utility
18 perform a system-integrated analysis of bids received by it using computer programs and modeling
19 designed for that function. It was Mr. Mitchell's view that such activities would enhance the utility's
20 ability to meaningfully evaluate proposals it had received as to price and deliverability. Further, such
21 activities would be supportive of the Staff's stated desire for a "comprehensive evaluation of all bids
22 received" [Ex. S-1, page 40, line 15]; and, they would enhance the prospects for a successful
23 solicitation. In this regard, several other witnesses spoke favorably of the types of evaluation
24 activities recommended by Mitchell. More specifically, in alluding to the type of modeling and
25 simulation program suggested by Mr. Mitchell, ACC Staff witness Kessler testified
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“ . . . it was our [i.e. Staff’s] belief that that [i.e. suggested type of program] would have been part of the, an integral part of preparing the needs assessment the utility would have been required to present to the Staff and the independent monitor.” [Tr. 93, lines 16-20]

Similarly, Tucson Electric Power Company (“TEP”) witness Hutchens testified that the detailed modeling and marketing analyses used by TEP to evaluate procurement proposals in operational and economic terms were in the nature of the program simulations Mr. Mitchell has recommended be used. [Tr. 479, lines 7-19] Also, see Ex. RUCO-2, page 1, lines 20-23; Ex. Panda Gila River - 3, page 13, lines 7-10; and Tr. 775, lines 15-22.

Under the solicitation timelines for RFP’s set forth in the Staff Report, the period of time allotted for the “evaluate prices” portion of the timeline may be insufficient to perform the system integration analysis recommended by Mr. Mitchell. However, the changes to the Staff’s proposed procurement process to provide the additional time required are relatively minor and can easily be accomplished within the overall timeline of the Staff’s proposal. [Tr. 776, lines 3-25] More specifically, the following minor changes indicate how the needed additional evaluation time could be incorporated without disturbing or extending the Staff’s proposed overall timelines.

- (A) The “Pre-solicitation” activities should cease immediately upon the Commission’s issuance of a decision on Track “B” issues. The “identify products and bidders” activity is unnecessary if an “all source” solicitation approach is to be implemented.
- (B) The “Solicitation Preparation” time allotment can be reduced by 30 days. An “all source” bid is an extremely simple solicitation that essentially asks potential bidders to present their best power sales options.
- (C) The “Evaluate Price” (line 24) and “Evaluate Deliverability” (line 25) activity periods can be extended to 30 days from the current allotment of 14 days. This extension of time is more than offset by the recommended reduction of time in the “Pre-solicitation” phase (30 days) and the “Solicitation Preparation” phase (an additional 30 days).

1 As indicated above, the added time for analysis and evaluation associated with an integrated system
2 analysis could easily be accommodated into the Staff's overall timeline proposal, and might even
3 allow the bid selection process to be completed at an earlier date.
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5 Sempra/ SWPG believe that Mr. Mitchell's suggestions are consistent with the "agreement(s)
6 in principle" reached during the Track "B" workshops; and that they supplement the marketers'
7 workshop input with additional utility resource planning perspective. In addition, they believe the
8 requirements for the information necessary for such integrated system analyses could be included
9 within the solicitation materials to be prepared by each utility, as contemplated by "agreement in
10 principle" 12(1)(b) and 12(1)(c). [Ex. S-1, page 33] Finally, each utility can undertake some
11 preliminary groundwork while it is preparing the solicitation applicable to its operations. It does not
12 need to wait until all proposals have been received before laying the foundation for the evaluation
13 phase of the process. Thus, as indicated above, the time required to perform the integrated system
14 analyses need not extend the overall timeline beyond what the Staff Report contemplates.
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17 **C. Exclusion of Demand Side Management and Environmental Risk Mitigation**

18 Sempra/SWPG agree with the Staff's recommendation that Demand Side Management
19 ("DSM") and Environmental Risk Mitigation ("ERM") should not be considered by the Commission
20 in the establishment of the initial competitive procurement process. [Ex. S-1, page 39, lines 6-20]
21 It may be appropriate to consider these matters in a separate proceeding or a subsequent solicitation,
22 but those issues do not require resolution at this time. Further, as the Staff Report suggests, while
23 bidders should not be required to include a DSM or ERM component as a part of their response to
24 a request for proposal, they should be allowed to do so if they so desire.
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III.

INTERMEDIATE AND LONG-TERM CONTRACTS

The Staff Report and the Track "B" hearings did not devote much time to the role that appropriately structured intermediate and long-term contracts can perform as part of a utility's power procurement portfolio. Sempra/ SWPG believe that the Commission's decision in Track "B" adopting a process for competitive solicitations should expressly recognize that appropriately structured intermediate and long-term contracts can and should perform a beneficial role in a utility's procurement of power.

Such recognition is both important and appropriate. In Decision No. 65154, the Commission made clear its desire to avoid the price volatility that had characterized California and other deregulated energy markets in recent years.³ That volatility was in large measure the result of undue reliance on the spot market. Moreover, in the Track "B" hearings, several witnesses have characterized the current western regional competitive wholesale power market as a "buyer's market" and one with a "glut of available capacity." A well conceived power procurement process should require that these circumstances be considered and evaluated to determine if longer-term contract offerings could be used to lock-in reasonable rates for electric consumers regardless of what happens in the volatile spot price wholesale market during the next few years.

In that regard, and against this background, APS inexplicably proposes to predicate its procurement strategy on a program consisting largely of spot market purchases; or what it calls "economy energy" purchases. However, as Sempra witness Mitchell testified, what APS actually proposes to do is quite different from what has traditionally been an "economy energy" transaction

³ Decision No. 65154, Finding of Fact No. 16, page 28; and page 22, line 27- page 23, line 4.

1 in the electric utility industry. [Tr. 756, line 1- Tr. 759, line 1] Furthermore, the short-term
2 procurement approach advocated by APS is fraught with potential problems for APS' customers and
3 the Commission.
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5 More specifically, if the current "buyer's market" should end and a "seller's market" began,
6 a run-up in wholesale power prices at the Palo Verde Hub similar to what happened during 2000-
7 2001 could occur. In this situation, a utility (e.g. APS) with a short-term procurement strategy would
8 be confronted with the dilemma of purchasing spot market wholesale power at escalating prices, and
9 simultaneously purchasing hedging options at ever increasing prices.⁴ Thereafter, when that utility
10 sought to recover its purchased power costs through an adjustment clause, its customers would
11 experience higher rates than would have been the case had the utility utilized a balanced power
12 procurement approach. In addition, the utility will be seeking additional funds at the same time the
13 unregulated merchant power plant business unit is likely experiencing extraordinary large profits due
14 to the same run-up in wholesale spot prices. History has demonstrated that is sometimes difficult
15 for a regulatory commission to focus completely on utility operations in situations such as this and
16 ignore the profits on the merchant plant side of a consolidated company when setting just and
17 reasonable rates for utility consumers. It is for these reasons that Sempra/ SWPG recommend that
18 the Commission's decision adopt a process which expressly considers intermediate and long-term
19 contracts in the bid solicitation process.
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26 ⁴ See Tr. 585 lines 12-16 where Mr. Carlson states that the costs of options increase as the cost of
27 the underlying commodity becomes more volatile.

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IV.
CONCLUSION

Sempra/ SWPG urge the Commission to issue a decision adopting the Staff's recommended competitive procurement process, as set forth in the Staff Report, subject to the preceding discussion and suggested modifications.

Respectfully submitted this 18th day of December, 2002.

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