



Arizona Utility Investors Association

2100 N. Central, Ste. 210
P. O. Box 34805
Phoenix, AZ 85067

Tel: (602) 257-9200
Fax: (602) 254-4300

Email: info@auia.org
Web Site: www.auia.org



BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL CHAIRMAN
JIM IRVIN COMMISSIONER
MARC SPITZER COMMISSIONER

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IN THE MATTER OF ARIZONA PUBLIC SERVICE)
COMPANY'S REQUEST FOR A VARIANCE OF)
CERTAIN REQUIREMENTS OF A.A.C. R14-2-1606)
IN THE MATTER OF THE GENERIC PROCEEDINGS)
CONCERNING ELECTRIC RESTRUCTURING.)
IN THE MATTER OF TUCSON ELECTRIC POWER)
COMPANY'S APPLICATION FOR A VARIANCE OF)
CERTAIN ELECTRIC COMPETITION RULES)
COMPLIANCE DATES.)
IN THE MATTER OF THE APPLICATION OF)
TUCSON ELECTRIC POWER COMPANY FOR)
APPROVAL OF ITS STRANDED COST RECOVERY.)
IN THE MATTER OF THE GENERIC PROCEEDING)
CONCERNING THE ARIZONA INDEPENDENT)
SCHEDULING ADMINISTRATOR)

DOCKET NO. E-01345A-01-0822
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AUIA'S CLOSING BRIEF IN THE TRACK B PROCEEDING

The Arizona Utility Investors Association (AUIA) hereby files its closing brief in the above-captioned proceeding, according to the instructions issued by the Administrative Law Judge (ALJ) at the close of hearing, November 27, 2002.

Introduction

AUIA will address the following issues in its closing brief:

1. Challenges to Track A

AUIA asserts that certain changes proposed by the Staff, if incorporated into a Track B order, would conflict with the Commission's order in the Track A proceeding and constitute an impermissible collateral attack on Decision No. 65154 adopted by this Commission Sept. 10, 2002.

2. Reliability Must-run Generation (RMR)

AUIA argues that Staff's proposals regarding RMR are inappropriate and contrary to the order in Track A.

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1 3. Expedited Approval/Price to Beat

2 AUIA argues that the Commission should adopt an expedited approval process.

3 4. Unmet Needs

4 AUIA believes that the Staff's approach to defining unmet needs is inappropriate
5 and contrary to the order in Track A.

6 5. Method of Solicitation

7 AUIA argues that the Commission should adopt a compromise approach to
8 soliciting for the utilities' unmet needs.

9 **1. Challenges to Track A**

10 The Staff advocates changes to the Staff Report (Exhibit S-1) issued on
11 October 25, 2002, in two key areas: a) by inserting the term "economically" in
12 several locations and b) including RMR generation in the contestable load of
13 Arizona Public Service Co. (APS) and Tucson Electric Power Co. (TEP).

14 Clearly, the Staff can amend its report at any time and in any way it chooses,
15 although we will argue that it may be intemperate to do so with regard to these
16 issues. However, we assert vigorously that if these changes should be included in a
17 Track B order, they would contradict the findings in Decision No. 65154 (Track A)
18 and would constitute an impermissible collateral attack on an existing decision of
19 the Commission.

20 See *Davis V. Arizona Corporation Commission*, 96 AZ 215, 393 Pac. 2nd 909, 1964;
21 See also *General Cable Corp. v. Arizona Corporation Commission*, 27 AZ App. 386,
22 555 Pac. 2nd 355, 1976;

23 See also *Arizona Public Service Co. v. Southern Union Gas Co.* 76 AZ 373, 265
24 Pac. 2nd 435, 1954.

25 These cases hold generally that a decision of the Commission can be
26 challenged only through a timely action brought in the Superior Court. In the
27 absence of pursuing such a remedy, the decision of the Commission is
28 conclusive and is not subject to collateral attack. What holds for the courts
29 certainly applies to collateral proceedings of the Commission if they are not
30 brought pursuant to A.R.S. 40-252.

31 With regard to the insertion of the term "economically": Staff witness Alan
32 Kessler asserts in his rebuttal testimony that the staff proposes to insert the word
33 "economically" at Page 4, Line 20 of the Staff Report (see Ex. S-3, P. 12, L. 3) and in

1 other relevant locations. The sense of this change is to dramatically alter the amount
2 of utility load that could be subject to bid under the terms of the Track A order.

3 The pertinent language in Decision 65154 says, "we will require APS and TEP
4 to acquire, at a minimum⁸, any required power that cannot be produced from its
5 own existing assets, through the competitive bidding process as developed in the
6 Track B proceeding." (see Dec. No. 65154, P. 23, L. 22-24)

7 As proposed by Mr. Kessler, the comparable language in the Staff Report
8 would read, "To the extent that a utility has load requirements, capacity or energy,
9 not served *economically* by generating capacity owned by the utility...that unmet
10 need will be acquired through a competitive solicitation." (emphasis added) (see Ex.
11 S-1, P.4, L. 20)

12 The clear meaning of Decision 65154 is that in the absence of divestiture, the
13 utilities will operate with their owned assets under traditional cost-of-service
14 regulation. Indeed, the testimony of Matthew Rowell, the Staff's policy witness in
15 the Track A proceeding, asserts that utilities that do not divest their generation
16 "should not be required to demonstrate that there are no current market-based
17 alternatives. In other words, utilities that choose not to transfer assets should be
18 subject to traditional cost-of-service regulation." (see Tr. P. 344, L.24-26)

19 In contrast, Mr. Kessler's proposed language would alter the meaning of
20 Decision 65154 and place more of the utilities' existing generation at risk for being
21 used and useful. It would make any part of a utility's generation portfolio
22 contestable based on undefined economic perceptions.

23 Mr. Kessler admitted as much on cross-examination when he was asked, "Do
24 you believe it was the Commission's intention that all of these units and all of the
25 load should be contestable?" His response, "Yes. I don't know what the
26 Commission's intention was, but it would not have been unreasonable for the Staff
27 to have said it's all contestable." (see Tr. P. 408, L. 5-12)

28 Certainly, Mr. Kessler's approach is incompatible with cost-of-service
29 regulation and with the intent of Decision No. 65154.

30 Likewise, with regard to RMR, Staff witness Jerry Smith notes that the Staff
31 Report did not include RMR capacity and energy as contestable loads for APS and
32 TEP. (see Ex. S-4, P. 4, L. 25) However, in his rebuttal testimony, Mr. Smith
33 advocates that RMR should be considered contestable for the 2003 competitive
34 solicitation. (see Ex. S-4, P. 5, L. 6)

1 This change should also be rejected because it contradicts the "existing
2 generation" provision of Decision 65154 discussed above and represents a collateral
3 attack on that decision.

4 On cross-examination, Mr. Smith conceded that the Staff's latest estimate of
5 APS's unmet needs was achieved by eliminating the must-run output of nine or 10
6 APS-owned units. (see Tr. P. 411, L. 3-12) When asked what authority he could cite
7 in Decision 65154 that would allow him to include utility-owned RMR in contestable
8 loads, Mr. Smith and his counsel stated that it was a matter of interpretation.

9 For support, Staff counsel cited the Commission's use of the phrase, "at a
10 minimum," in Decision 65154 (see Tr. P. 412, L. 6), to wit: "...we will require APS
11 and TEP to acquire, at a minimum⁸, any required power that cannot be produced
12 from its own existing assets, through the competitive bidding process..." (emphasis
13 added).

14 Staff fails to note the Commission's inclusion of a footnote to clarify the
15 phrase, "at a minimum." The footnote explains the phrase as follows: "8 APS and
16 TEP may decide to retire or displace inefficient, uneconomic, environmentally
17 undesirable plants." (see Dec. No. 65154, P. 23, L. 27)

18 Here, the Commission is merely accounting for the possibility that either of
19 the utilities might retire some generating plants and, if so, the load served by those
20 plants would become contestable. There is no suggestion that the Staff, in its own
21 discretion, or a separate proceeding could redefine what is contestable beyond the
22 parameters of the Track A decision.

23 2. RMR Generation

24 In addition to the reasons cited previously, the Commission should reject
25 inclusion of RMR in the 2003 solicitation because a) it serves no public purpose; b) it
26 is premature, ahead of completion of the required RMR studies; and c) it is
27 destabilizing to the financial community.

28 According to testimony, RMR loads in the Phoenix and Tucson load pockets
29 are not accessible to generators external to the load pockets. For example, TEP
30 witness David Hutchens testified that no merchant generator could supply must-run
31 generation during peak periods without building new transmission into the Tucson
32 area or new generation inside the load pocket. (see Tr. P. 437, L. 7-22)

33 Nevertheless, the Staff has suggested that up to 1,000 gigawatt hours of RMR
34 energy should be added to TEP's unmet needs. (see Tr. P. 429, L. 7-9)

1 Mr. Hutchens argues that no public purpose would be served by including
2 RMR in the 2003 solicitation. (see Tr. P. 438, L 7-10) On the contrary, he asserted that
3 including such speculative numbers would muddy the waters for financial analysts
4 and rating agencies that are trying to understand the impact of the competitive
5 solicitation on the utilities. (see Tr. P. 433, L. 24 - P. 434, L. 25)

6 Other considerations aside, Mr. Hutchens stated that RMR generation should
7 not be included as contestable load until the mandated RMR studies can be
8 completed and evaluated. (see Tr. P. 439, L. 5-12)

9 On surrebuttal, APS witness Steven Wheeler also emphasized that
10 determinations of contestable load have significant financial ramifications. He
11 asserted that, "...to my knowledge, there is no precedence around the country for
12 bidding out company-owned RMR resources in situations that are comparable to
13 those that we face in the Valley or in Yuma." (See Tr. P. 504, L 24 - P. 505, L. 3)

14 Mr. Wheeler added, "This discussion about contestable load is not just an
15 esoteric numbers debate. We have the same concern that TEP does that there can be
16 important financial implications associated with using numbers in an inappropriate
17 way," and he quoted a Standard & Poor's report, "The ACC's treatment of these
18 facilities as rate base assets will be key to Pinnacle West and APS's credit quality."
19 (emphasis supplied) (see Tr. P. 507, L. 17 - 21 and P. 508, L. 17 - 19)

20 AUIA contends that the Commission should not include large, fictional RMR
21 numbers in contestable load merely on the gamble that some sort of market
22 response may appear. This proposal conflicts with both the Track A order and the
23 Staff's position in that proceeding and it may be destabilizing to utility finances.

24 3. Unmet Needs

25 The arguments over this issue were an exercise in mind-numbing semantics,
26 with no clear conclusion. Staff's Exhibit 5 is hardly dispositive, since Mr. Smith's
27 methodology for calculating APS's unmet need is not evident and an energy number
28 for TEP is still forthcoming (as far as we know).

29 Nevertheless, AUIA is willing to accept the word of Mr. Kessler and Mr.
30 Smith on the reasons for the differences between their calculations of unmet needs
31 and those of the companies.

32 In his rebuttal testimony, Mr. Kessler complained that APS defined its unmet
33 needs "as the difference between its forecast load and all capacity and energy it was
34 physically capable of producing, irrespective of the cost of that generation." (see Ex.

1 S-3, P. 7, L. 16-18) He cited the Staff definition of unmet need as “the difference
2 between a utility’s capacity and energy requirements, and the amount of capacity
3 and energy that it has available to it at reasonable and competitive cost.” (see Ex. S-3,
4 P. 6, L. 23-25)

5 He then asserted that APS’s definition significantly reduced the amount of
6 energy APS has available for competitive solicitation compared with the company’s
7 estimates in the Track B workshop. (see Ex. S-3, P. 7, L 23-24)

8 AUIA is not at all sure that Mr. Kessler accurately describes the basis of the
9 differences between APS’s and the Staff’s calculations of unmet needs, but assuming
10 *arguendo* that he is right, it simply demonstrates, once again, that the Staff, in this
11 proceeding, chooses to ignore or rewrite the Commission’s Decision in Track A.

12 The APS definition of unmet need, if Mr. Kessler’s description is accurate,
13 nevertheless matches Decision 65154. Mr. Kessler’s does not. (It is worth noting
14 that Decision 65154 was issued subsequent to the Track B workshop session in
15 which APS produced the unmet needs estimate that Mr. Kessler is using as a
16 baseline calculation.)

17 Meanwhile, Mr. Smith asserts that TEP’s unmet energy needs are understated
18 by as much as 1,000 gigawatt-hours, related entirely to must-run requirements. (see
19 Tr. P. 289, L. 3-15) Although the Staff’s final number is still pending, AUIA believes
20 it should not be relevant, since it depends on the exclusion of utility-owned
21 generation, in opposition to the terms of Decision 65154.

22 It is understandable that the merchant generators would campaign for the
23 largest possible calculation of unmet need because it enhances, at least superficially,
24 their bidding opportunities. However, the commission should be cautious not to
25 adopt numbers that inflate expectations unrealistically and may also produce
26 negative financial consequences for the utilities.

27 **4. Expedited Approval/Price to Beat**

28 Both APS and merchant generators have argued for an expedited approval of
29 contracts accepted under the bidding protocol, although for somewhat different
30 reasons. As Mr. Kessler noted, the merchants want expedited approval as a
31 financing tool. (see Ex. S-3, P. 4, L. 17-18) However, Staff witness Ernest Johnson
32 asserted that APS is “simply seeking to shift the risk of cost recovery away from
33 itself to consumers.”(see Ex. S-2, P 3, L 13-15)

1 On cross-examination, APS witness Wheeler disputed that assertion and
2 indicated that the company was seeking expedited approval on a contemporaneous
3 basis as a means to mitigate the increased risk to the bidding process of a later
4 finding of imprudence. Mr. Wheeler testified:

5 "I would make the argument that if the Commission is willing to provide a
6 degree of approval to the process it has mandated, that the companies' attempt to
7 buy power under that process and the bidders' desire to bid aggressively with good
8 pricing, will ultimately be to the customers' benefit. And that rather than shifting
9 the risk to customers, I think customers will get a better deal in the long run from a
10 process that has Commission buy-in at the front end rather than an uncertain result
11 at the tail end." (see Tr. P 552, L. 24 - P. 553, L. 10)

12 Both Mr. Johnson and Mr. Kessler offered rebuttal comments suggesting that
13 the competitive solicitation process, without expedited approval, poses no more risk
14 to the utilities than their current practice of acquiring power supplies from the
15 market. (See Ex. S-2, P. 2, L. 21 - P. 3, L. 2 and Ex. S-3, P. 6, L. 11-15)

16 The Staff Report had proposed the Price to Beat as a compromise measure to
17 mitigate the risk for both the utilities and merchant generators. (see Ex.S-2, P. 5, L.
18 13-15) However, in his rebuttal testimony, Mr. Johnson withdrew the Price to Beat,
19 at least partly on grounds that elements of the proposal drew significant criticism
20 from various parties. (see Ex. S-2, P. 6, L 7-12)

21 Thus, while arguing on the one hand that competitive solicitation does not
22 pose unusual risks, the Staff acknowledged a certain level of risk in the bidding
23 process by offering a compromise mechanism to mitigate risk. By withdrawing the
24 Price to Beat, the Staff leaves no semblance of protection from findings of
25 imprudence that could occur months or years after the fact.

26 In the final analysis, Mr. Kessler and Mr. Johnson argued that the
27 Commission is too inexperienced in competitive solicitation to be sure that its
28 judgments will not result in excessive costs to ratepayers, especially if they are made
29 too quickly. (see Ex. S-2, P. 4, L 12-14 and S-3, P. 4, L. 19-22)

30 Mr. Wheeler countered on cross-examination that the Commission's heavy
31 involvement in the bidding process should enable it to reach a timely judgment on
32 prudence. He testified:

33 "As we understand the Staff Report that Staff would ask the Commission to
34 approve, we would be told how much to bid. We would be told when to bid and

1 when to test the market. We would be told what type of information has to be
2 prepared and submitted to the parties, a preparation submission that would also
3 require third party review. We would be told what means we can communicate
4 with participants. We would be subject to monitoring and critiquing by Staff and
5 the independent monitor virtually every step of the way. And there would be limits
6 on the type of utility personnel that could be involved.

7 "Given that degree of involvement in the process, we think that also would
8 suggest it's appropriate to get Commission involvement and approval of the process
9 at its conclusion." (see Tr., P. 511, L. 1 - 16)

10 The basic test of prudence is what was reasonably known at the time the
11 decision was made. The utilities' nightmare is that prudence will be decided long
12 after the decisions were made, tainted by intervening circumstances and perfect
13 hindsight. For example, TEP's rates are frozen for five more years and the company
14 won't see a rate proceeding until 2008.

15 AUIA believes the Commission should re-evaluate the Staff's position to
16 arrive at a workable risk mitigation strategy rather than leave the regulatory risk
17 entirely on the buyers and sellers.

18 **5. Methods of Solicitation**

19 This is an issue that rests on close questions and judgment calls that are
20 largely outside of AUIA's experience, but the basic issues seem relatively clear:

21 APS wants to bid for some capacity to fulfill its unmet needs, but it wants to
22 meet its energy requirements primarily through economy purchases in the spot
23 market at times of its choosing. Because of long experience with economy
24 purchases, APS is confident it can manage the risk in the spot market.

25 The merchant generators would prefer APS to bid more substantial contracts
26 consisting of capacity and dispatchable energy, which they believe offers APS the
27 best of both worlds. Such contracts presumably would have greater economic value
28 to the suppliers and would give the merchants a bigger bite at the apple in the initial
29 solicitation.

30 The Staff, represented by Mr. Kessler, concedes that APS could meet its
31 obligations through economy purchases but argues that the utility should first test
32 the market by soliciting for all of its unmet needs "in a fair and transparent
33 solicitation." (see Ex. S-3, P. 8, L 17-19) Then, according to Staff, the utility is free to
34 make a choice, to accept some bids it receives or move on to the spot market.

1 Or, as Mr. Kessler suggests, "Soliciting for all of energy reasonably expected
2 to be purchased from third parties, that is to say unmet needs as defined b y the
3 Staff, during the initial solicitation does not obligate the utilities to purchase all of
4 the power sought during the solicitation." (see Ex. S-3, P. 10, L 5-8) (emphasis
5 supplied)

6 AUIA offers two comments regarding this standoff:

7 First, the Commission should heed the Staff's first imperative, as articulated
8 by Mr. Johnson: "Staff's proposal in Track B leaves the utility with the ultimate
9 decision-making authority regarding its needs and the ultimate responsibility to act
10 prudently." (see Ex. S-2, P.4, L. 3-4)

11 If that is true, then the Commission should not dictate the manner of
12 solicitation to the utilities. For example in his rebuttal, APS witness Thomas Carlson
13 offered a compromise involving quarterly mini-actions of economy energy. Even if
14 this option is appealing to the Commission, it should be the utility's choice.

15 Second, Mr. Kessler's proposal to test the market with a single, transparent
16 solicitation is commendable in a theoretical sense, but it contains a political trap.

17 Mr. Wheeler notes that frustrated expectations could induce complaints and
18 litigation. (see Tr. P. 509, L. 7-11) Furthermore, it is unthinkable that a regulated
19 utility, faced with apparently reasonable bids from hungry merchant generators,
20 would take the political and regulatory risk of casting them aside and ordering its
21 troops to the Anzio Beach of spot market purchases. No, once bid, once bought,
22 and you have to hope it's right for the consumers.

23 **Conclusion**

24 First, there was the Brave New World of retail competition and the
25 Commission saw the need for utilities to divest their generating plants to affiliates,
26 and adopt codes of conduct to regulate their behavior in a competitive environment.

27 Next, there was no competition and the Commission saw a need to stop
28 divestiture in its tracks. This called for a return to cost-of-service regulation, but
29 with a new directive to prop up the wholesale market with competitive bidding.

30 Now, we are trying to determine how much risk the utilities must accept in
31 order to meet the new directive. Make no mistake. That is what Track B is about.

32 At some point, this Commission must decide that enough is enough, that it is
33 time to stop digging in the sand on which the utilities are trying to stand.

1 In the last analysis, AUIA asks just three things from the Commission in this
2 proceeding:

- 3 • That the Track B decision is consistent with Track A;
- 4 • That it does not send another message to the financial community that the
5 sands are still shifting in Arizona;
- 6 • And that the utilities are given flexibility to carry out the responsibilities
7 for which they will be held accountable.

8
9 RESPECTFULLY SUBMITTED this 18th day of December, 2002,

10 

11 _____
12 WALTER W. MEEK, PRESIDENT

13
14 **CERTIFICATE OF SERVICE**

15
16 Original and eighteen (10) copies of this Brief
17 were filed this 18th day of December, 2002, with:

18
19 Docket Control
20 Arizona Corporation Commission
21 1200 W. Washington Street
22 Phoenix, AZ 85007

23
24 Copies of the referenced Brief
25 were hand-delivered this 18th day of
26 December, 2002, to:

27
28 William A. Mundell, Chairman
29 Hercules Dellas, Esq.
30 James M. Irvin, Commissioner
31 Kevin Barlay, Esq.
32 Marc Spitzer, Commissioner
33 Paul Walker, Esq.
34 Christopher Kempley, Esq., Legal Division
35 Ernest Johnson, Esq., Utilities Division
36 Teena Wolfe, Esq., Hearing Division
37 Arizona Corporation Commission
38 1200 W. Washington
39 Phoenix, AZ 85007

40
41 Copies of the referenced Brief were faxed
42 or mailed this 18th day of December, 2002, to:

43
44 Appropriate parties of record