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RE

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November 13,

Ernest Johnson,
Utilities Division Director
Arizona Corporation Commission
1200 W. Washington
Phoenix, AZ 85007

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RE: Comments in anticipation of the November 19th Track B Workshop NOV 13 2003

The members of the Arizona Competitive Power Alliance appreciate the opportunity to participate in the Track B Follow-Up Workshop.

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The initial results of the Track B solicitation demonstrate that Arizona consumers were clearly the big winners. The Independent Monitor's Final Report indicated that \$70 million in savings were achieved for APS' ratepayers alone, and an additional \$1-2 million for TEP's customers from these first solicitation processes. The Alliance believes that this preliminary estimate of savings may be conservative and that greater savings will be revealed as the results of the Track B solicitation are subject to further analysis. The Alliance is eager to work with all stakeholders to ensure future solicitations result in continued savings for Arizona consumers.

Competitive solicitation processes play an integral role in advancing wholesale competition. Competitive solicitations are essential to achieve the best deal for ratepayers in terms of price, risk, reliability, and environmental performance. The ACC wisely chose to use the Track B competitive procurement process as the mechanism to accomplish a measured transition to competition. Competition did occur, and ratepayers achieved appreciable savings as a result.

The solicitation had secondary benefits as well. The daily interaction and cooperation between the utilities and new merchant generators via this process is evidence of added savings and increased reliability that can be fostered by wholesale competition. For example, member companies of the Alliance are producing and selling power under APS' secondary procurement protocol. In addition, merchant generators have played a key role in meeting the needs of Arizona consumers during recent generation and transmission outages that could have otherwise impacted reliability.

Notwithstanding its successes, the Alliance believes that the Track B solicitation, should be viewed from a critical perspective to ensure continued process improvement. As Staff correctly predicted,¹ there are lessons to be learned from

¹ Staff Report on Track B: Competitive Solicitation in Docket Nos. E-00000A-02-0051 et al; October 25, 2002; page 1.

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the first round of solicitations that can be applied to future processes. The earlier collaborative workshops were helpful in focusing constructive stakeholder input, allowing questions to be addressed quickly and collectively. The Alliance valued the work of the Accion Group which effectively served to allay concerns and proactively addressed questions that arose during the process. Though the Alliance membership continues to have concerns in the areas of transparency and potential affiliate bias, the role of an Independent Monitor hired by Staff was a positive development in the solicitation process. In addition, in future solicitations, Alliance members would appreciate the opportunity to consider collaboratively other procurement formats and product types.

In summary, the Alliance believes that the Track B solicitation resulted in significant savings for Arizona consumers, that the use of such solicitations is an appropriate, measured step to encourage wholesale competition, and that the solicitation process can be refined and improved for the future. For these reasons, the Alliance is extremely concerned about APS' proposal to set aside the PWEC Track B contracts within only a few months of finalizing them and rate-base the associated assets. In the Alliance's view, APS' proposal effectively makes the Track B solicitation a sham, negating the cost savings achieved for ratepayers and undermining the development of the competitive wholesale market in Arizona.

To further its own profit-driven objectives in the rate case, APS has unfairly characterized the Track B solicitation as a failure:

The recent Track B initial solicitation process, although widely publicized and anticipated in one form or another, for several years, drew so few bids in such meager quantities for so little duration that the outside merchant industry's ability to meet APS customer needs in even the short run is seriously in doubt.

Wheeler at 28

This statement is untrue. Notwithstanding concerns about transparency, affiliate bias, and other issues detailed below and in the attached comments, many members of the Alliance participated in the Track B solicitation processes for both APS and TEP, and at least two member-companies executed contracts with the utilities as a result of the solicitation. Those contracts provide significant savings to Arizona ratepayers today and will for the next two years. In addition, APS' complaint about the duration of offers is misleading. At its core, the Track B process was a power procurement for a three-year period. Generally speaking, in such a limited term procurement APS should have not been surprised if it did not receive many offers of longer duration.

These types of issues are not unusual in a newly-designed process. The Alliance views the efforts of all stakeholders to address these issues simply as

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refinements to procedures that have already proven beneficial to the citizens of Arizona. Making a good process even better provides the framework for additional consumer savings in the future.

Alliance members have a strong interest in serving Arizona. As mentioned previously, with a few improvements, even greater participation is the likely outcome for future competitive solicitations. Throughout the country—from Colorado to Oregon to New Jersey to Maryland—companies like those that are members of the Alliance have been vigorously involved in the collaborative process and the ultimate procurement process.

To encourage robust participation and fully realize future benefits, we believe the following specific modifications of the Track B bidding process should be considered:

- The vagueness of the Market Manipulation Statement caused otherwise qualified bidders in the Alliance to reject the bidding process and ultimately provided fewer choices and potentially higher prices for consumers.
- Credit policies continue to provide an artificial barrier to nonaffiliated competitors. Since APS and PWEC are under the same corporate umbrella, one must question how PWEC is able to provide credit protection equivalent to that demanded by APS of other unaffiliated bidders.

One of the stated concerns in the process was APS' requirement that collateral posting would be incremental, meaning if a bidder was to fall below BBB/Baa2, then it would be posting an Independent Amount plus a Performance Assurance Amount plus any amount over its collateral threshold. In addition, there is a serious concern that these terms (and levels) are not bilateral (i.e., in the base EEI contract, one doesn't find reciprocal credit assurance requirements of APS).

- The \$10,000 bid fee proved to be a high hurdle for some bidders who believed that their bids would be summarily rejected as non-conforming — despite offering low prices as an enticement. Other approaches are used elsewhere in the country, for example, in Maryland where the utilities pay all costs of the solicitation process.
- While we appreciate the Independent Monitor's vigilance regarding any potential self-dealing between related parties during the bidding process, we continue to be generally concerned about the potential for cross-subsidization of the fixed and variable costs (between APS and PWEC) related to affiliated generation in the upcoming APS rate case.

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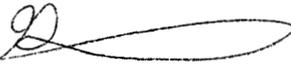
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- Participants may have been unwilling to commit to an extended commercial contract that contained a broad "regulatory out" for the Buyer, which could have forced the Seller to incur uncompensated losses (e.g., hedging or lost opportunity costs).
- In the next Track B collaboration, the potential consumer benefits of different products and longer-term contracts should be explored.

Clearly, Track B has been a success to-date from the consumer standpoint. It has also been a learning process for all participants. We believe there is much more that can be learned and much that needs to be addressed before the next solicitation. It is our hope that this workshop will shed some light on the remaining issues and allow the second round of bids to progress more smoothly, with greater merchant participation, a wider breadth of products offered, and ultimately provide even more benefits to consumers in the future.

In addition, the Alliance has provided an Attachment to this letter, which delineates the successes of the Track B solicitation processes, separately categorized for APS and TEP. It highlights the issues that need to be addressed going forward in order to improve the process before the next round of RFPs.

Sincerely,



Greg Patterson
Director

Attachment to Alliance Comments Letter dated 11/13/03

Alliance Participants' Evaluation of the Overall Track B Process

What Worked Well

TEP

- From the initial bidders' conference through the contract execution, the process was cooperative and fair. TEP was responsive to bidder comments in the pre-bid conference and was open to alternative products or "non-conforming" products proposed by the bidders that could meet their system needs.

APS

- Once in motion, the solicitation itself ran well. The bid review, efficiency of the contracting, notification and communication and award process was positive.
- The iterative process for establishing a baseline EEI contract was productive. All bidders were working from the same baseline terms and conditions in the EEI when they submitted their proposals.

Areas for Improvement -- APS

- **Communication.** The APS website was ineffective early in the process. There was also confusion about whether all comments and questions would receive a response from the Company. The problem was ultimately resolved.
- **Standard Contract.** Changes to the "standard" EEI should be minimized. Specifically, insertion of onerous Availability Factor formulas or one-sided credit arrangements frustrate the bid process. (See also bullet 4)
- **Bid Fee.** Each potential bidder had to evaluate the risk/reward (cost/benefit) of participation in the eventual bid process. The \$10,000 bid fee was one consideration of the cost of participation given the probability of success that was considered by each potential bidder. If increased participation is the desire for the next bid process, and the Alliance believes that that is an admirable goal, we would recommend a reduction or elimination in the bid fee.

- **Market-Based Bid Criteria.** Bid conditions and contract terms need to be market-based. Reciprocal credit arrangements are a market standard in the industry. APS proposed that the supplier would provide APS with credit assurance, but reciprocally APS committed to provide no credit assurances to the supplier. Although there was some movement and improvement on this issue during the pre-bid time period, the bidders were left with a decision as to whether to submit a “non-conforming” bid to provide for a standard market contract. There was further discomfort with what priority and review “non-conforming” bids would receive in the bid review process.

- **Undefined Risks.** Another factor in the risk/reward analysis was the guarantee against market manipulation that was incorporated into the bid process. Although the language was narrowed and refined considerably within the final 8 hours prior to the bid deadline, the language left some companies in a position to not be able to adequately evaluate the implications of the guarantee. There were no definitions provided surrounding the concepts of “allegation” or “market manipulation”. In a highly-sensitive environment surrounding the California crisis, the ENRON bankruptcy and the cascading financial crisis in the industry, we understand and accept the message that was associated with this bid criteria. We believe that we could work together collaboratively to address the fundamental issue in a way that would not dampen participation by Alliance members and others in the merchant generation business in the next solicitation.

- **Shadows of doubt.**
 - The Order gave the latitude to the utilities to reject all bids. In one company’s viewpoint, there was no assurance that the \$10,000 bid fee wasn’t simply being paid to permit price discovery by APS and TEP.
 - Any bid process that involves an affiliate’s participation is ripe for gaming and will likewise reduce the number of active participants. The independent monitor managed the issues to the best of their ability given the time granted for establishing the process and the rules. The monitor raised the need for greater separation in their Final Report. Greater transparency is required and higher standards in affiliate codes of conduct are needed to provide assurance to bidders that gaming of the RFP process to affect a predetermined outcome is reduced to a very low probability. A much higher level of transparency is required in load forecasts and need determinations (this changed many times throughout the process), product definitions and bid selection criteria. In addition, the RMR study needs to be more transparently developed, including the participation of non-incumbent market-participants, and open to public comment. The benefits from plants other than under the ownership of PWEC/APS in regard to ensuring the continued reliability of the system could be greater than indicated in the RMR study performed by APS, parallel to this process.

- APS was already sending signals (Post letter from July 2002) that they would seek rate-based treatment of the PWEC assets. Thus no other bidder would have the opportunity to advance a case for increased revenues after the bid process was finalized. This left a shadow of doubt as to the bidding practices of PWEC, particularly given what was later filed in the rate case.

What does the Outcome Convey About the Process?

- The traditional business standard of requesting bids from potential suppliers yields positive and measurable benefits to the consumer. The provision of electric service is no different than that of other services procured by either public or private entities. The consumer wins in a bidding process.
- The outcome conveys that even when the solicitation process had need for improvements, the results to ratepayers were stunning - \$70 million of savings for APS' ratepayers alone.

Identification of Modifications to the Process as Appropriate.

TEP

- Given the absence of an affiliate generator as a bidder, we believe that the Independent Monitor and \$10,000 bid fee are not required for future TEP solicitations. Should a TEP affiliate choose to participate in future solicitations, then the same conflict of interest issues and concerns arise that are highlighted herein in connection with APS and PWEC.

APS

- The potential for online auctions could enhance the process. APS indicated a desire to migrate toward this method over time. On-line auctions have worked in other jurisdictions and could work in Arizona as well, though their implementation is most applicable for acquiring standard products, which is a subset of the utilities' overall needs. Given that much of the utilities' needs are non-conforming to standard products, there will always remain a requirement for an unabridged process with bilateral negotiations for non-standard products. Other potential processes and products should be investigated in future procurement processes, also.
- Utilize a more standard EEI contract, including reciprocal credit arrangements and balanced terms and conditions.

- More clarity and quantitative information for each transmission delivery point,
- Elimination or clarification of “guarantee” required in bid process.
- Elimination or reduction of bid fee. With the millions of dollars of benefit realized from the bidding process, ratepayers should be willing to absorb the cost of an RFP process and would benefit from participation of those suppliers that may sit on the sidelines.
- Remove the shadows of doubt in the market structure for Arizona through greater transparency, stronger affiliate codes of conduct that greatly reduce potential for gaming and provide increased regulatory certainty for market participants. “Stay the course” with only a few improvements to make an already good process better.