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AZ CORP COMMISSION
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February 25, 2002

VIA HAND-DELIVERY

Chairman William A. Mundell
Commissioner Jim Irvin
Commissioner Marc Spitzer
Arizona Corporation Commission
1200 W. Washington
Phoenix, Arizona 85007

E-00000A-02-0051
E-01345A-01-0822
E-00000A-01-0630
E-01933A-02-0069
E-01933A-98-0471

Re: *The Cooperatives' Responses to Electric Competition Rules Questions;*
Docket Nos. RE-00000C-02-0051 and E-00000A-01-0630

Dear Commissioners:

Enclosed are the responses of the Arizona Electric Power Cooperative, Southwest Transmission Cooperative and Sierra Southwest Cooperative Services (collectively "the Cooperatives") to the questions posed by each of you. These responses are submitted without waiver of the positions taken and issues stated in Phelps Dodge et al v. AEPCO, et al., No. CA-CV01-0068 and No. CV1977-03748 (Consol.)

The Cooperatives have focused these responses primarily on generation and transmission issues. Several of the Cooperatives' member distribution cooperatives are submitting separate responses directed primarily to distribution related matters.

Certain questions posed by you venture into areas which the Cooperatives did not have the internal or external resources nor, in some cases, the time or direct experience to address adequately. A "no response" does not necessarily indicate no opinion or position, but rather reflects these factors.

Arizona Corporation Commission
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Commissioner Jim Irvin
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The Cooperatives appreciate this opportunity to provide input on these issues and reserve the right to change or supplement answers based on further developments. We look forward to continued future participation in these dockets.

Very truly yours,

GALLAGHER & KENNEDY, P.A.



By:
Michael M. Grant

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COMMISSIONERS QUESTIONS AND RESPONSES

Electric Competition Rules:
AISA:

Docket No. RE-00000C-02-0051
Docket No. E-00000A-01-0630

Commissioner Mundell's Questions

I. Identification of Retail Electric Products and Services for Which Competition Could Bring Benefits.

- A. What are the possible goods and services traditionally provided by the electric utility for which retail competition is possible? You may address the following categories of goods and services:
1. generation, including baseload, intermediate and peaking power; green power; distributed generation; firm and non-firm power; long- and short-term contracts; backup and coordination services:

Response:

Retail competition in power delivery clearly is possible. Whether it makes sense for the vast majority of customers is an issue subject to serious debate. In rural areas, the Cooperatives believe that the risks and costs associated with competition far outweigh any possible benefits associated with it.

Retail competition through distributed generation owned by or leased from an entity offering the service—one that is not the traditional host utility – offers various alternatives including serving remote loads or improving power quality to a customer. Further, distributed generation is also changing the way host electric utilities conduct business by offering alternatives to the traditional building of central generating facilities and the necessary transmission systems and distribution systems upgrades. While customers have long had the ability to “self-generate” using distributed generation, a lack of customer expertise, up-front costs and operating considerations have often stood in the way for such customers.

2. distribution services, including ownership, construction, maintenance and repair of the physical lines; metering ownership, installation, reading and data analysis; and the process of planning for and negotiating with distributed generators:

Response:

Please see the distribution cooperatives' response.

3. aggregation services, such as load profiling; load planning; customer services; data analysis; billing; generation planning; power supply acquisition; demand side management, energy efficiency and other services relating to matching supply and demand.

Response:

With the exception of aggregation and power supply acquisition services, all other customer services listed have long been offered by competitive suppliers in the energy services field. They have never been considered solely functions of certificated public service corporation services. As well, some of these services, e.g. demand side management and energy efficiency, have also been offered by traditional host utilities. Large commercial and industrial customers with incentives to reduce costs will still continue to shop for most of these services whether or not competition in electric generation exists. Similarly, smaller commercial customers, when advantageous, will seek out billing aggregation services that receive, review and bundle a customers' multiple utility bills into a "one-pay" bill while performing other energy services, such as data analysis, performance contracting, etc.

- B. For each good or service for which competition is possible, what are the possible benefits of competition for each good and service?

Response:

Theoretically, competition supplies goods and services efficiently and at a lower cost. However, the lessons of competitive generation experiments in California, Texas, Pennsylvania and elsewhere are that competition does not necessarily bring benefits; instead, many have found that its burdens can be substantial.

1. What are the potential price benefits?

Response:

See the distribution cooperatives' response. For generation, potential price benefits will vary widely based on customer class, size and load characteristics – particularly if traditional regulatory cost of service cross subsidies are removed.

2. Do the potential price benefits differ in the short-term and long-term?

Response:

See the distribution cooperatives' response. For generation, short-term and long-term benefits may vary widely – depending upon, among other things, market supply and demand conditions.

3. What are the potential non-price benefits?

Response:

No response.

4. Are there any other potential benefits (e.g., environmental, energy security, etc.)?

Response:

Distributed generation can provide some or all of a customer's electrical needs. A co-generation system - the addition of a heat recovery system to the generator - uses the waste heat from the generator for water heating, space heating or other thermal needs. The cost effective applications of distributed generation for both customers and utilities are:

1. *Delaying or deferring transmission and distribution system upgrades,*
2. *Providing peaking power to reduce demand charges,*
3. *Providing continuous power at a higher level of reliability and/or power quality than may be available from the grid,*
4. *As a co-generation system, improving the customer's overall efficiency of its facilities, and*
5. *Providing ancillary services such as spinning and non-spinning reserves, reactive supply and voltage control.*

II. Determination Of The Feasibility Of Competition.

- A. Are the product and geographic markets for the good or service conducive to effective competition or manipulation by a single entity? For example--
 1. Are there economies of scale which make it most efficient for the service to be provided by a single company?

Response:

Certainly, a large body of classic economic thought supports the concept that many utility services are most efficiently supplied by a single provider.

2. Are there economies of scope which make it most efficient for the service to be provided in a bundle with certain other services?

Response:

Electric generation and transmission was once competitively provided – at the end of the nineteenth century and the beginning of the twentieth – when electric service was in its infancy. The highly capital intensive nature of the industry, high cost of that capitalization, long lead times for recovery of costs, consequent economies of scale required, public distaste for overlapping utilities' wires, potential for interference with system reliability, dearth of service provided to rural areas, high cost of service to residential load compared to low rate of return and economic inefficiencies of that market segment, along with refusals to serve, unreasonable discrimination, price gouging, predatory pricing, cherry picking (and cream skimming) and other abuses led to a demand for a monopolistic electric utility market.

Many of the basic rationales for bundled service by a single retail provider still remain: residential service is costly to maintain (low load factors, high distribution costs, high customer service costs, high individual transaction costs); economic inefficiency and reliability problems in multiple overlapping distribution systems; economies of scale in the provision of bundled services; undesirability of geographically dispersed rural and low load factor loads, and the practical difficulty for market generators in providing anything but wholesale service.

Nevertheless, larger, high load factor customers chafe, and rightly so, at not reaping the benefits of their load desirability. Historically, such customers have subsidized the high costs of other customers. As regulatorily captives, the only way regulators permitted utilities to offer large customers "discounted" contracts was through their demonstration of the economic feasibility of self generation. Consequently, they ultimately demanded a nationwide move to competitive electric generation. In retrospect, having learned the lessons of California, Pennsylvania, and Texas and recognizing that no electric service provider really wants residential customers in a competitive marketplace, perhaps the best solution would have been to permit large customers to pay a true cost-of-service rate, negotiating contracts that more closely reflect the actual cost of service provided.

- B. Are or will there be a sufficient number of competitors in each potentially competitive market?

Response:

No, see above response. No electric service provider wants to serve undesirable loads: residential, geographically disbursed or low load factor customers are some examples. A competitor needs to believe there is a potential to realize profits. Certain loads by their nature are unlikely to provide them.

1. Is the product or service one which viable competitors will actually be interested in providing?

Response:

See prior responses. Distributed generation is one such product; there is a current market and it is being served by a number of non-traditional entities.

2. Is the cost of aggregating customers sufficiently small, relative to likely revenues, which new suppliers will find it profitable to enter?

Response:

It is unlikely residential and many commercial loads can be made profitable. Aggregating these loads does not improve this situation.

3. Are there technical, legal or other barriers to entry in the markets? For example:
 - a. Are there legal or technical barriers to the construction of the different types of generation plants by non-utilities?

Response:

A primary significant Arizona legal barrier is the Certificate of Environmental Compatibility process.

- b. Is the cost of obtaining licenses, resources, knowledge and employees sufficiently small, relative to the expected revenues, such that new entrants will find the market attractive?

Response:

Certainly various costs and uncertainties may deter new entrants. The Cooperatives are not certain if they have yet risen to a level where that is actually occurring. Recently, however, there has been a sharp downturn in new power plant construction interest.

- C. Is it necessary for the product or service to be provided by a single regulated company to assure reliability and safety, or can multiple companies provide the service subject to reliability and safety rules?

Response:

Multiple companies can provide the service. Whether that produces the most economical, reliable and secure product delivery is a significant question. The level of complexity and regulation and their costs to integrate fully multiple suppliers ranging from billing through generation is significantly increased.

- D. For customers, is the cost associated with learning how to shop and actually shopping sufficiently small, relative to the expected benefit, that customers will want to shop?

Response:

Both the risk and cost associated with shopping is sufficiently high so as to deter many small residential and commercial loads from undertaking the assignment.

III. Relationship Of The Current Regulatory Regime To Competition.

- A. For each potentially competitive product or service, how does current state and federal regulation foster or inhibit (a) retail competition and (b) wholesale competition?

Response:

At the inception of the ACC's rule-making on electric competition, the ACC formed a legal workgroup chaired by the ACC's chief counsel and composed of stakeholders' lawyers (from utilities, new market entrants, consumer groups, etc.). The group worked numerous hours to author a volume of work which in large part answers these questions; that work, filed by the legal staff in the Rules docket, seems to have been long overlooked. This re-examination of the rules would be a good time to dust it off. It provides a good background for these issues and includes a fairly comprehensive legal discussion on a number of topics critical to this process.

A part of that discussion concerns the Arizona Constitution. The Cooperatives' position is that the Commission cannot authorize "market based rates" and individually negotiated outcomes without amendments to Article 15 of the Arizona Constitution. Article 15, Section 3 requires the Commission to prescribe classifications and rates--not the market--and Section 14 requires the Commission to prescribe rates based upon a consideration of the fair value of the provider's property devoted to public use. Article 15, Section 12 requires nondiscriminatory rates for similarly situated customers. In other words, a regulated "cost-based" system is mandated by the Arizona Constitution and the Commission can't change that without a constitutional amendment. The report also discusses necessary statute changes needed to accommodate competition.

- B. How can the Commission protect Arizona customers from the risks of competition while promoting competition?

Response:

In general, the Commission cannot do both, nor appropriately should it "promote" competition by attempting to structure a marketplace, disadvantage existing utilities and advantage new market entrants.

True competitive markets develop on their own to meet market demand, service needs, price tolerance and product need. Sufficient antitrust rules exist to deal with anti-competitive behavior. Further, the FERC is empowered to and does regulate transmission access and anti-competitive conduct. To try to do more simply distorts and can impede the natural development of a new industry.

- C. How have the interim rate reductions for customers receiving standard service affected the ability or desire of generation suppliers to compete in Arizona retail markets?

Response:

The Cooperatives believe that interim rate reductions are not the cause for the failure of generation suppliers to compete in Arizona retail markets. The responses set forth above detail the difficulties in serving a residential market. Further, almost all ESP's were interested only in commercial and industrial customers whose "rate reductions" were not significant enough to prevent price competition from ESP's. Perhaps of more import, through early 2001, competitive generators could realize greater profits for far less effort by selling exclusively in the wholesale market. Indeed, many still refuse to provide any product but hour ahead and other short term sales, even in the wholesale market. Independent power producers and merchant plants have remained wholesale sellers of power largely by choice because the market has rewarded that choice.

- D. Do Commission policies or legal requirements ensuring that utilities recover investments from ratepayers affect the prospects for competition in any market for which competition otherwise would be possible?

Response:

Certainly stranded cost recovery can affect the market in the short run.

- E. Does continuing utility control of depreciated generation assets affect the ability of competing suppliers to enter retail markets?

Response:

Not necessarily. Many of the new gas-fired plants are highly efficient, have low heat rates, a small work force and are run from a central location which reduces overhead, all of which keep costs low. Any prudent competing retail supplier would purchase from both merchant plants and older generation plants as part of its resource portfolio.

- F. How does current Commission regulation promote or deter the ability of (1) renewables, (2) distributed generation, and (3) energy efficiency and demand side management to compete with traditional generation resources?

Response:

See responses of distribution cooperatives and other responses on distributed generation.

- G. What are the risks of moving to a regime of retail competition for each product or service and what are the methods for managing those risks?

Response:

In general, the rural areas are at particular risk for reasons explained previously. Rural areas are not desirable markets generally. Further, the loss of certain desirable loads drives up costs for remaining customers. Managing those risks requires a recognition of these issues and special treatment concerning rural areas.

- H. If the current regime is not conducive to retail competition for a particular product or service, what actions should the Commission take to promote its success in the future? Specifically—
1. Should the Commission require existing utilities to procure particular products or services from unaffiliated competitors?

Response:

No, for both legal and practical reasons. Utility micro-management is neither permissible nor desirable.

2. Are utilities taking steps that will make competition more difficult down the road?

Response:

The Cooperatives are not taking any such steps.

3. Are utilities entering into long-term contracts with existing customers? If so, how do they affect prospects for future retail competition? Should the Commission allow them?

Response:

Long term contracts are necessary in certain situations for a variety of reasons. Often, they are with larger, more sophisticated customers which have other options and benefit both the customer and the Cooperatives' remaining customers. The Commission should allow them.

4. Should the Commission consider instituting competition for billing and metering services even if retail generation competition is premature?

Response:

No. See distribution cooperatives' responses.

IV. Retail Generation Competition.

- A. Regarding each identifiable generation product--
 1. Identify with particularity any defects in the wholesale market structure affecting Arizona.

Response:

No response.

2. Are there an adequate number of competitors to sell in Arizona to make the product sufficiently competitive? How many sellers are there?

Response:

The Cooperatives are not certain of the precise number of sellers, but there are certainly a number of competitive plants being built or planned. Whether it is an adequate number depends on a variety of factors including demand, actual completion of plants and sales and operational strategies.

3. How have mergers and consolidations in the industry affected the competitiveness of the product in the region at the wholesale and retail levels?

Response:

No response.

4. Are competitors building new generation able to price their generation at rates competitive with existing generation?

Response:

Yes. See response to III, E above.

5. How has the Independent System Administrator affected the success of (a) retail competition and (b) wholesale competition?

Response:

The Arizona Independent System Administrator (AISA) does not initiate, create or drive either retail or wholesale competition. The energy market does. The AISA only provides a monitoring service of third-party independent wholesale transmission transaction(s) to give a higher comfort level to those third-parties that the transactions will be fair because they are monitored. Since those third-parties also have access to FERC procedures (including a telephone complaint hot line) for complaints about those same wholesale transactions, the AISA has no effect on the success or lack of success of Arizona competition, especially at the retail level. The protocols produced have been useful in standardizing processes which can be used once competitive transactions occur. However, such protocols could have been produced by other means and can now be used absent the AISA's existence.

- B. Regarding the transmission and distribution infrastructure necessary to support competition for each identifiable generation product--
 1. Are there transmission constraints inside or outside Arizona that currently impede the ability of competitors to reach Arizona customers during any reasons of the year or times of the day?

Response:

Transmission constraints exist inside and outside Arizona. They are physical and/or contractual and exist at all times of the year. The FERC's requirement of open access transmission coupled with the recognition by incumbent utilities in their OATT that the same transmission that served a monopoly customer will serve a competitive customer will solve the contractual constraints. Building more transmission facilities in accordance with the FERC's requirements will relieve the physical constraints.

The SWTransco transmission system, with all lines in service, currently has adequate transmission to import power to meet local demand (and customer choice) without the need for local generation. Under certain critical single contingency line outages, however, some local generation is must run.

SWTransco is participating in an EHV transmission study with other utilities and independent power producers. The study is called the Central Arizona Transmission System (CATS) Study and encompasses an area bounded by the Phoenix Metropolitan area to the north and the Tucson Metropolitan area to the south. The purpose of the CATS study is to evaluate the long term high voltage transmission facility needs for central and southeast Arizona.

2. What plans are in place to relieve transmission constraints?

Response:

The CATS study group has completed initial studies that address the physical limitations on today's transmission system to deliver the future generation patterns to the anticipated load centers. The group is proceeding with determining alternative transmission additions to provide the needed transmission capacity in future years.

SWTransco plans to build a new 230 kV transmission line (Winchester Interconnect) which will eliminate the need for local generation to serve local area demand under a single contingency outage. With the Winchester Interconnect in place, SWTransco will have no transmission constraints on its system for importing power to serve local demand.

3. How long will it take to relieve any existing transmission constraints and what factors are affecting and will affect prospects for relief?

Response:

Relieving any existing transmission constraints could take several years. For example, SWTransco is planning to build the Winchester Project. The Winchester Project will include a new substation that ties into a TEP 345 kV line along with construction of 23 miles of double circuit 230 kV line from the new substation to Apache Station. This will provide additional transmission capacity to deliver Apache or other generation. This project is one of the projects identified in the CATS study to provide needed transmission capacity. The Winchester Project will take three years to place into service from initial planning, if no unexpected hindrances are encountered. The other projects identified in the CATS work are greater in scope and cost. The factors affecting these projects' in-service date will be issues with siting, permitting and financing. Any delay in obtaining one item could delay the entire project.

4. Are the owners of constrained transmission facilities, or holders of transmission rights, able to use their control to affect market prices?

Response:

Economic theory states that limited transmission capacity will affect market prices because it would limit lower cost generation from getting to market and do so at the expense of the end-user of electricity. However, the economic dispatch policies of most utilities often belie that economic theory. More often, transmission constraints limit the importation of power from other generators or the construction of new generation in certain areas since the cost of building both generation and needed transmission can make a project too costly and, therefore, non-competitive. This is because the transmission system was privately built by each utility to deliver power and energy from a generator to its retail load; it was not designed as a public roadway to maximize the movement of power for all comers. FERC now has in place rules that govern the conduct of transmission owners, of rights holders and of users.

SWTransco operates its transmission system in accordance with its FERC approved Open Access Transmission Tariff (OATT), which provides for comparable treatment for all transmission customers. SWTransco has no control over generation facilities other than contracting for generation services to maintain the reliability of the transmission system under the guidelines of its OATT.

5. Are these transmission owners currently doing things that will allow them to exert more or less control in the future? If so, please detail.

Response:

Less control. As discussed above, the transmission system was built by each transmission owner to serve its utility system and needs. By following FERC open access regulations enacted over the past several years, originating the AISA, participating in the formation of Desert Star and its successor WestConnect, posting on the OASIS and planning and construction of new facilities to accommodate new generation plants and wheeling for non-native loads, transmission owners are continuously ceding more and more control of their owned facilities to others. SWTransco, like other transmission owners, is planning, building, and operating its transmission system to meet its contract load requirements in accordance with FERC open access requirements. Also, in providing equal access and comparable service on its transmission system, it will continue to operate and control its transmission system to the extent allowed by FERC rules to maintain a reliable operating transmission system.

6. Will the transmission system be adequate prospectively (e.g., in the next 5, 10, 15, 20 years) to deliver power from new generation plants?

Response:

If all entities, including developers of the new generation plants, timely follow the FERC regulations (as they are required to do) for planning, studies, interconnection and facility construction, and, assuming prompt siting approval and the ability to secure adequate rights of way, the transmission system will continue to meet the needs of new plants as well as existing and future load.

The SWTransco transmission system with the addition of the Winchester Project will have adequate capacity to deliver the output from Apache Station and its planned 38 MW addition. New generation plants anticipated to be built by merchant power developers and traditional utilities may require new transmission facilities and upgrades to existing facilities. The existing Arizona intra-connected transmission system will not be able to deliver the power from all planned new generation plants until more of the planned transmission facilities are built over the next several years.

Nevertheless, with the Winchester Project in place, SWTransco's transmission system will be able to provide import capability for local demand well into the future. Based on

current load forecasts, no new EHV lines will need to be built to accommodate local demand growth through the next 20 years, although some lower voltage facilities will need to be upgraded or replaced as necessary.

7. Is the natural gas pipeline infrastructure adequate to support all proposed new gas-fired generation plants? How many plants can it support?

Response:

All of AEPCO's generating units, including several that are fueled with natural gas, were built to serve the needs of its member cooperatives and their customers, and not for making merchant sales to outsiders. However, AEPCO has discussed possible participation in merchant plants with others as an alternative solution to meet its own growing load. Accordingly, our answers regarding these matters must be understood to be based upon our incidental analysis rather than on any direct insider information.

In AEPCO's view, the reliability of gas supplies for the proposed new merchant power plants in Arizona is a major issue facing merchant plants, especially if they must rely on a single natural gas pipeline to deliver their gas supplies. In particular, sponsors of merchant plants that would be served by the El Paso Natural Gas Company ("El Paso") will need to obtain firm transportation rights on a pipeline that has, for some time, been unable to provide consistently reliable transportation for its existing firm customers, and as a consequence is having to defend itself against complaints filed at FERC by several of its customers (including AEPCO). Such complaints variously seek to force El Paso to expand its system to meet its contractual obligations, and/or to refrain from signing new contracts until it has proven it can carry out its existing ones. Of course, if a merchant plant sponsor already has firm transportation rights on El Paso, it presumably would not have to overcome opposition from existing El Paso customers in order to gain access, but it would face the same uncertainty that existing customers do with respect to El Paso's reliability as a transportation provider.

In the long run, in AEPCO's view, the current capacity shortfall on El Paso will be redressed through a combination of system expansion and market adjustments, so that its customers, both existing and new, will again be able to count on getting all the gas to which they are entitled. In the short run, however, gas delivery reliability can be a significant risk for many proposed new merchant plants in Arizona.

Of course, the Desert Crossing pipeline and storage project and the recently proposed Red Lake gas storage project in Mohave County, if built, can significantly alleviate a number of these gas transportation concerns.

8. Does the transmission and distribution system facilitate or deter--
 - a. the development of renewable energy technologies?

Response:

If other than customer on-site technology, the location and size (power output) of the renewable energy technology will dictate whether the transmission and distribution system facilitates or deters its use, i.e., central station or distributed generation (see response to Question 8.b. below). If the renewable energy technology is central station, then its location and its impact on the transmission grid due to that location (and size) will determine availability. If it is located so that facilities are needed to mitigate its impact on the existing transmission system, then a higher transmission cost would be assigned to it and the transmission system would be viewed as deterring the resource. However, note the fact that it is renewable has no effect on the analysis, it is the size and location of the resource that governs.

Much of the service area of SWTransco and its member distribution cooperatives is rural and remote. Renewable energy technologies such as solar photovoltaic can be efficiently used in some cases to provide electricity to remote areas. In such instances, the cost and availability of the transmission and distribution systems can be the driving force for selecting or locating a renewable resource.

b. the development of distributed generation?

Response:

The transmission and distribution system can facilitate the development of distributed generation as Arizona continues to grow. As the need for system additions grows, distributed generation can be a cost-effective alternative. In certain cases, the use of distributed generation can be a cost effective means of deferring, and possibly eliminating, the need for transmission and distribution facility additions. Also, distributed generation may be a viable option for an aging distribution system requiring major upgrades.

Because of the rural and remote service area of SWTransco and its member distribution cooperatives, distributed generation can be a very viable and cost effective means of providing power.

Further, AEPCO, SWTransco and their members are supportive of distributed generation particularly as a means of serving remote areas and providing additional reliability as well as an added business opportunity. System protection is required for distributed generation for the protection of both the personnel and facilities of the owner and of the local distribution company. Most utilities understand that distribution generation is a viable option for a customer and have established reasonable standards for the protection of all parties. Others, however, have erected barriers to losing a customer and only talk about interconnect requirements, while not acting to establish any interconnection standards. The way to resolve this issue is to establish uniform and reasonable standards for interconnected facilities, whether by FERC at the transmission level, or by the ACC at the distribution level, so that each party specifically knows in advance what is expected.

- c. the development of demand-side management and energy efficiency?

Response:

As stated in the response above concerning distributed generation, the costs, need for expansion and location of the transmission and distribution system can also facilitate the development of demand-side management and energy efficiency due to the need to continually build transmission and distribution facilities to meet system growth. The use of demand-side management and energy efficiency programs may be a cost effective means of deferring, and possibly eliminating, transmission and distribution facility additions.

- C. Regarding competitive bidding—
 - 1. Identify with particularity any adverse consequences that would result from Commission approval of a substantial variance to the electric competition rules that require competitive bidding for 50% of the electric supply for standard offer customers, starting in 2003. Specifically:

Response:

Because the rule applies only to investor owned utilities and not cooperatives, the Cooperatives will leave to those affected by the rule comments on its problems or advantages. Because of financial, mortgage and all requirements contract issues unique to the Cooperatives, it is vital that their exemption from this requirement be maintained. AEPCO has all requirements or, in one instance, partial requirements contracts with its member distribution cooperatives requiring them to purchase all or substantially all of their electricity from AEPCO through 2020. AEPCO's mortgage and the mortgages of each distribution cooperative are premised upon performance of these agreements. The Cooperatives' ability to secure future financing for necessary generation and distribution maintenance and improvement projects are also tied to performance of these agreements. A requirement that the distribution cooperatives purchase power from others through competitive bid would violate these agreements, cause mortgage defaults and imperil the ability of the cooperative system to obtain necessary financing.

- a. How would retail customers be affected?

Response:

See response above.

- b. How would retail generation competition be affected?

Response:

See response to C.1 above.

- c. How would wholesale generation competition be affected?

Response:

See response to C.1 above.

2. Are sufficient competitors available for an effective bidding process for 50% of standard offer service? A higher or lower percentage?

Response:

See response to C.1 above.

3. Can retail competition develop if current rules are modified to allow a utility to procure all its generation for standard service from an affiliated company?

Response:

See response to C.1 above.

4. How would retail competition be affected by other deviations to the competitive bid rules? Be specific about the changes in the rules and their consequences.

Response:

See response to C.1 above.

5. Instead of entertaining individual requests for substantial variances to the competitive bid requirements, should the Commission proceed on a generic basis to modify the rules for competitive bidding?

Response:

See response to C.1 above.

6. If the Commission would change the 50% bidding requirement for standard offer service, are there other specific measures the Commission can take to promote retail competition?

Response:

See response to C.1 above.

- D. Regarding the pricing of power supply contract rates—
1. Identify any advantages that would result if the Commission approved a long-term supply contract for standard offer customers that was based solely on cost-based rates. (Your answer should define “long term” as compared with “short term contract.”)

Response:

See response to Question C.1 above.

2. What if the contracts are based solely on market-based rates?

Response:

See the response to Question C.1 above.

3. Describe how FERC’s new approach for analyzing the ability of sellers with market rate authority to exercise market power affects generation companies selling into Arizona.

Response:

FERC’s new approach for analyzing the ability of wholesale sellers with market-based rates to exercise market power (which also entails preventing the exercise of that market power and ordering after-the-fact refunds if that power is exercised) is designed to prevent a recurrence of the sorts of price spikes that recently afflicted California. In the short-term, the policies will likely limit power prices (although power prices have recently been quite low in the West and most other areas). Since the rules are proposed to apply nationally, Arizona is unlikely to be disproportionately affected and Arizona’s relative attractiveness as a power market should not be altered.

However, and of lasting importance, in the longer-term, the new policies have ample potential to prove counter-productive and eventually culminate in price spikes. The new policies essentially prevent wholesale sellers from recovering much more than their incremental production costs. While some of the policies apply only to sellers with market power, those that lack market power will also be unable to obtain premium prices on a sustained basis. As a result, sellers may find it difficult to recover their substantial capital costs in generation plants and new entry will be discouraged.

Merchant plants, peaking units and Western utilities generally appear particularly vulnerable. Merchant plants, which serve no native load, will be vulnerable as they must

compete for all of their sales. The problems will be acute for peaking units that run relatively few hours each year and seek to recoup their capital costs through scarcity premiums. Also, the West, unlike some Eastern markets, generally has no mechanism for crediting generators for installed capacity, as opposed to actual sales. Consequently, the new policies substantially increase the risk that growing demand will outstrip supply, creating a capacity crunch that will culminate in price spikes. For the reasons stated, the problems may be especially acute in the West. The ultimate result may be precisely what the new policies are ostensibly designed to prevent, namely a recurrence of a California-type situation, albeit on an even larger scale, and, ironically, for many of the same reasons, that is, an effort to divorce market prices from the full costs of production.

4. Does the Commission have the ability to assure that approval of a long-term contract would protect ratepayers receiving standard offer service as well as foster competition?

Response:

See the response to Question C.1 above.

V. Industry Events External to Arizona.

- A. Describe in detail developments you believe will occur in both the wholesale and retail competitive electric generation markets nationally and in Arizona over the next 12 months, 24 months, 36 months, 48 months and 60 months.

Response:

No response.

- B. Is there anything the Commission should do to continue to avoid California's retail electric competition experience? Please be specific.

Response:

The safest course of action, placing legal issues to one side, is to wait until there is a fully developed market at wholesale to assure ample supply for the foreseeable future. Even then, however, certain markets will be unserved or underserved and consumers generally will be subject to future market volatility.

- C. Does the Enron bankruptcy have any lesson for retail electric competition in Arizona?

Response:

Yes:

1. *That not everything comes quickly nor should it.*
2. *That competition in the electric industry does not, in and of itself, automatically carry benefits to consumers.*
3. *That the legitimate business objective of energy trading and merchant marketers is realizing a profit on the transactions they undertake and that higher profits can be made in a market environment that is characterized by price volatility, inefficiency and a general lack of vigorous competition in the wholesale market.*
4. *That there is value in hard assets.*
5. *That consumer protection and customer service comes from utilities with a history of production and delivery of energy to consumers as their primary business, not as only a small part of their portfolio.*

D. How will FERC's RTO initiative affect the realization of effective retail generation competition in Arizona?

Response:

The effect is unclear. The theory is that an RTO will facilitate open access transmission and make more efficient use of the existing transmission system. This is to be accomplished through an independent central operator who will route delivery through unconstrained paths, dispatch least-cost units regardless of contract requirements (making later balancing payments as compensation), plan for the most efficient system additions, etc. However, RTO's are a new creature. Those working well are an outgrowth of already in-place power pools located in small geographic markets.

Further, and perhaps as importantly, there has been no cost-benefit analysis conducted by FERC to demonstrate their usefulness to end-use customers. Their purpose is to promote and facilitate competition – a policy choice. Apparently forgotten in the \$120 to \$150 million RTO start up costs and \$100 million in annual RTO operating costs is the requirement that they benefit those whom the industry was originally designed to serve – consumers. The majority of an RTO's functions are currently already being provided by existing utilities. An RTO only adds another layer performing essentially duplicative functions to meet the policy goal. There has yet been no demonstration of market power or failure of open access in Arizona which would require an RTO as a solution needed to accomplish retail (or even wholesale) competition.

- E. Do you anticipate changes in federal utility statutes to affect the jurisdiction of the Commission and its ability to foster retail competition in Arizona? Please detail.

Response:

That appears unlikely at this time. Although numerous bills are pending in Congress, it seems the majority preserve states' ability to regulate or determine the timing and structure of retail competition within their borders.

VI. System Security

- A. Are there compelling reasons to be concerned about security for electric generation facilities since the Sept. 11, 2001 tragedy? Please include discussion of interconnection at a central location such as Palo Verde/Hassayampa.

Response:

No response.

- B. Does transferring ownership of generation facilities out from traditional Commission jurisdiction have any potential negative security consequences?

Response:

No response.

- C. What if ownership after transfer results in a foreign corporation eventually controlling Arizona's generation?

Response:

No response.

- D. Does such a transfer to a non-Arizona entity potentially impact security issues for Arizona?

Response:

No response.

- E. Are there any positive security aspects to transferring electric generation out from Commission traditional regulation to a foreign corporation?

Response:

No response.

- E. Provide specific examples to support your answers.

Response:

No response.

VII. Vision

Please provide your vision for how viable competitive wholesale and retail electric markets will (or will not) develop in Arizona. Please be specific regarding dates, the development process, and measures for determining at various stages how successful the process has been.

Response:

The Cooperatives have grave doubts as to whether retail competition will develop and benefit rural Arizona. Experience in the airline, banking and telecommunications fields demonstrates that such initiatives usually leave rural areas unserved or underserved. Wholesale competition may offer new opportunities to acquire, through various means, least cost resources throughout the state.

Commissioner Mundell's Supplemental Questions

Corporate Structure and Affiliate Relations.

1. If the U.S. Congress repeals the Public Utility Holding Company Act of 1935 ("PUHCA" or "Act") PUHCA--
 - a. what regulatory protections would be lost for Arizona customers?

Response:

These PUHCA issues are not relevant to the Cooperatives. We also do not believe we have adequate expertise or experience with the issues to respond meaningfully.

- b. what would be the risks of Arizona consumers?

Response:

See prior response.

- c. for any identifiable risks, are the risks reduced or increased under a competitive retail regime?

Response:

See prior response.

2. What is the extent of the Commission's authority to protect retail consumers from any potential adverse consequences resulting from multistate companies operating in either wholesale or retail markets in the state?

Response:

See prior response.

3. How would the existence of effective retail competition in Arizona affect our responses to Questions 1 and 2 above?

Response:

See prior response.

4. What is the extent of any impact on effective federal or state regulation to protect Arizona wholesale and retail consumers, if a holding company is (a) registered or (b) "exempt" under PUHCA?

Response:

See prior response.

Questions Specifically for Retail Suppliers as Defined Above.

5. Explain the retail supplier's corporate structure.

Response:

Sierra is an ESP certificated by the Commission. It is a non-profit member owned cooperative with three classes of members. Class A members are six Arizona and California distribution cooperatives. Class B members are AEPCO and SWTransmission. Class C members are others which receive services from Sierra.

6. Identify all subsidiary companies and the businesses in which they are engaged.

Response:

Sierra has no subsidiaries.

7. Identify all affiliate companies and the businesses in which they are engaged.

Response:

Sierra has no affiliates as that term is normally used in for profit, stock corporations.

8. Identify each entity that owns or has control of 5% or more of an affiliate of the retail supplier, and describe the businesses in which that entity is engaged.

Response:

Not applicable.

9. Describe the financial relationships among the various affiliates and subsidiaries, such as pledges of assets and encumbrances and contracts for services and goods.

Response:

Not applicable.

10. Explain whether the retail supplier, or any affiliate or subsidiary of the retail supplier, is regulated by the Securities and Exchange Commission (SEC) as either an "exempt" or "registered" public utility holding.

Response:

Sierra is not regulated by the SEC.

11. Identify any waivers or "no-action" letters the retail supplier, its affiliates, its subsidiaries, or other associated companies has received in the last 15 years from the SEC under PUHCA or the Investment Act of 1940 or from FERC under the Federal Power Act.

Response:

In conjunction with the RUS approval of the AEPCO restructuring, AEPCO, SWTransmission and Sierra obtained a PUHCA "no action" letter.

12. Provide copies of filings to the SEC and FERC made by retail supplier and any affiliates or subsidiaries in the last five years pursuant to the agency's administration of PUHCA.

Response:

See attached "no action" letter.

13. If the retail supplier is a subsidiary of a registered holding company, identify any SEC-approved contracts with affiliates or subsidiaries in the last five years.

Response:

Not applicable.

Divestiture or Corporate Separation.

14. How would the divestiture or transfer of assets of vertically integrated utilities now serving Arizona affect the Commission's regulatory authority over the divested entities? What controls or limitations might the Commission place on divestiture or transfer of assets to limit any loss of authority over the divested assets?

Response:

Cooperatives, of course, are not vertically integrated. Distribution is separate from generation and transmission. Generally, however, the divestiture or transfer of assets to wholesale entities will remove them from Commission jurisdiction.

15. How would the divestiture or transfer of assets of vertically integrated utilities now serving Arizona affect federal jurisdiction under the FERC and the SEC over the divested entities?

Response:

See prior response.

16. How would the potential effects of divestiture or transfer of assets on Commission authority differ under a competitive retail regime than under a monopoly regime?

Response:

See prior response.

17. How would a requirement that competitive services, such as generation services, be offered only through a separate corporate affiliate affect the Commission's regulatory authority and any risks identified in response to the questions above?

Response:

The Cooperatives do not believe there should be any such requirement for both jurisdictional and practical reasons. Jurisdictionally, the Commission has no such authority under the Constitution or statutes. Practically, among other things, it denies both to the competitive and regulated customer economies of scope and scale. It also hampers the cooperatives' efforts to generate replacement revenues and hold down costs as a result of revenues lost to competition.

18. For any risks resulting from a divestiture requirement or a requirement that competitive services be offered through separate affiliate, how might those risks be eliminated or reduced? Specifically--
- a. What actions might the Arizona Commission take?

Response:

See prior answer.

- b. Are there actions that the Commission might encourage the FERC or the SEC to take to maintain adequate oversight for the protection of ratepayers?

Response:

See prior answer.

Commissioner Spitzer's Questions

1. In a vertically integrated utility model, what incentives (regulatory, financial and ratemaking) exist for the expanded use of renewable energies?

Response:

Obviously, in a regulated model, the regulator may assure a revenue stream to support renewable applications regardless of whether they are a least cost solution.

2. In a competitive electric market model, what incentives exist for the expanded use of renewable energies?

Response:

In general, none. However, competitors may seek out "niche" markets for renewable applications.

3. In a vertically integrated utility model, what disincentives (regulatory, financial and ratemaking) exist for the expanded use of renewable energies?

Response:

To the extent that a regulatory goal is to deliver power to the consumer at least cost, renewables often cannot meet that test. Also, a regulator may mandate certain renewable requirements, but not provide a revenue stream sufficient to support them. Cooperatives also face a unique financing challenge in that their primary lender, the RUS, generally requires that loan funds may only be secured for least cost projects. Most renewables will not meet that test.

4. In a competitive electric market utility model, what disincentives exist for the expanded use of renewable energies?

Response:

To the extent that the market looks only at cost, renewable energies are normally more expensive.

5. During Arizona's period of reliance on the vertically integrated utility model, what renewable energy programs were enacted in Arizona?

Response:

Renewable energy matters were dealt with as part of the IRP process. A.A.C. R14-2-701 et. seq.

6. Since Arizona's adoption of a competitive electric market model, what renewable energy programs have been enacted in Arizona?

Response:

The EPS Rule. R14-2-1618.

7. Under the vertically integrated utility model, what incentives exist to build newer plants that are less damaging to the environment to replace older, dirtier plants?

Response:

Under either regulation or competition, an incentive may exist to remain with installed, depreciated resources. On the other hand, if newer more efficient plants are economically beneficial, then they may be constructed.

8. Under the competitive electric market model, what incentives exist to build newer plants that are less damaging to the environment to replace older, dirtier plants?

Response:

See prior response.

9. Under the vertically integrated model, what disincentives (regulatory, financial and ratemaking) exist to build newer plants that are less damaging to the environment to replace older, dirtier plants?

Response:

See prior response.

10. Under the competitive electric market model, what disincentives exist to build newer plants that are less damaging to the environment to replace older, dirtier plants?

Response:

See prior response.

11. During Arizona's period of reliance on the vertically integrated utility model, what emphasis did the Commission place on pollution control measures in Certificates of Environmental Compatibility?

Response:

Very few power plants were certificated in this time period. Research was not performed on this issue. However, the Cooperatives assume that any CECs' included the statutory condition that facilities meet the requirements of the agency with primary jurisdiction.

- (a) What is the most stringent pollution control measure placed on a CEC during Arizona's reliance on the vertically integrated utility model?

Response:

See prior response.

12. Since Arizona's adoption of a competitive electric market model, what emphasis has the Commission placed on pollution control measures in Certificates of Environmental Compatibility?
- (a) What is the most stringent pollution control measure placed on a CEC since Arizona's adoption of a de-regulated utility model?

Response:

It would probably be the LAER condition imposed in the Duke II rehearing.

- (b) What is the likelihood that that measure would have been placed on a similar CEC in a vertically integrated utility model?

Response:

This is a difficult question to answer because the Commission's view of its jurisdiction under the siting statutes has changed radically in the past two years. The Cooperatives assume that the Commission might be less inclined to impose costly conditions on "regulated" plants because it would then have to approve higher rates to support them.

13. During Arizona's period of reliance on the vertically integrated utility model, what amount of excess generating capacity existed in Arizona?

Response:

This figure has varied widely as new plants have come on line creating excess capacity at that time and then, over time, demand approached supply and new facilities were constructed – repeating the cycle.

14. Since Arizona's adoption of a competitive electric market model, what amount of excess generating capacity existed in Arizona?

Response:

Excess capacity existed a few years ago. That obviously constricted in 2000-2001.

Commissioner Irvin's Questions

I. Arizona Independent Scheduling Administrator

Commissioner Irvin's questions regarding the AISA's continued operation invoke jurisdictional principles and are perhaps best addressed through a review of those principles.

The Federal Power Act grants FERC direct jurisdiction over wholesale power sales and transmission by public utilities. Jurisdiction over retail sales and distribution is then left to the states.

This delineation is essentially a function of Congress's exercise of the powers available to it under the United States Constitution and the associated doctrine of preemption. For example, FERC presently does not have jurisdiction over most wholesale sales and transmission in Texas because that state's transmission grid (ERCOT) is deemed not to be interconnected to those of other states. Congress could likely grant FERC jurisdiction over wholesale sales and transmission in Texas, just as it could grant FERC jurisdiction over retail sales and distribution generally, subject only to a possible limitation based on states' rights (which would probably be unsuccessful).

Introducing competition through formal unbundling, be it through offers of Standard Offer service or the transfer of operational control of the transmission grid to ISOs/Transcos/RTOs, thus alters the balance between FERC and state authority. What was a single "bundled" retail sale becomes separate transmission and distribution components (and potentially wholesale and retail components), and FERC claims jurisdiction as to the transmission (both retail end-use and wholesale) and wholesale generation sale components. State jurisdiction does not end entirely, but is confined to the distribution and retail components of generation. (These matters are implicated in the appeal of Orders Nos. 888 and 889 pending before the Supreme Court. Under Enron's view, FERC jurisdiction and the associated open access requirements would attach to the transmission portion of bundled retail sales, and under the State of New York's view, FERC would lack jurisdiction over the transmission component of unbundled retail sales.)

The preceding discussion of governing principles provides answers to the specific questions presented. Arizona's authority to regulate the pricing of in-state services by public service corporations is defined, in the first instance, by what the federal government permits or does not preempt, as the Arizona Constitution cannot confer authority that has been preempted by Congress acting under the United States Constitution. Under FERC's current approach, unbundling causes FERC jurisdiction to attach to the transmission and wholesale portions of the sales, although Arizona retains jurisdiction as to the distribution and retail portions of the sales.

Additionally, utilities could certainly modify their transmission tariffs to conform to the AISA protocols so that retail transactions can occur without the AISA itself (although the protocols themselves might have to be changed so that they no longer incorporate the AISA as an ongoing entity). We are unaware of any dispute that the AISA has resolved involving specific transmission issues for retail competitive transactions (as opposed to differing positions over what the protocols themselves should or should not include).

II. Retail Electric Competition Rules ("Rules")

Re: Retail Markets limited by load size/IPP markets:

Summarizing what we set forth in previous responses, residential and small commercial and industrial service are essentially undesirable loads because they do not provide the profits and rate of return that wholesale sales do. They are costly to maintain (low load factors, high transactional costs of dealing with multiple UDCs, high customer service costs, high individual transaction costs, economic inefficiency, reliability problems), often undesirable in location, e.g., geographically dispersed rural areas and generally consist of low load factor loads – requiring the dedication of capacity that often sits unsold. Further, there are practical difficulties for market generators in providing anything but wholesale service. It is much easier and far more rewarding to market power only for sales for resale. A competitor needs to believe there is a potential to realize profits. Certain loads by their nature will never provide them.

Re: Establishing wholesale markets first:

It's easier to establish wholesale markets first because regardless of the nature of the retail market, whether traditional or competitive, as growth occurs and older plants deteriorate, more generation is needed and new generation, if competitively priced, will find a market. Once that is established - its establishment is having its own set of problems - and a ready supply of competitively priced wholesale generation is available, retail competition can begin, if suppliers see the potential for profit from the efforts needed to make retail sales. Without such a ready source, the risks of supply price and availability are too high for suppliers to undertake.

Re: Volatility of pricing and long term wholesale power contracts:

The only solution to such rate volatility is a commitment of the electric service provider to long-term (minimum five year) least cost resources, whether through construction of plants or in purchase power agreements; even then costs increase over time and the generator is assuming the risks of production: outages, fuel price volatility, etc. As to the relationship of fuel price to market volatility, since AEPCO is not a merchant marketer, its answers regarding these matters must be understood to be based upon an incidental analysis rather than on any direct insider information.

Having said that, we would not expect to find that the recent volatility in natural gas prices had a material effect on merchant plant risk. We say this because the economics of gas-fired power generation depend less on the absolute level of natural gas prices at any given point in time, than on the relative level of such prices compared to the prices being paid for the electric power being generated -- in other words, the "spread" facing the merchant generator. Because the spikes in natural gas prices we saw over late 2000 and the greater part of 2001 were accompanied by even greater spikes in the prices Arizona merchant generators were receiving, especially from California buyers, we would expect merchant plant operators to have done well financially despite high gas prices. Moreover, given the high degree of interdependence between demands for natural gas and for electricity (not only because higher demand for power drives unregulated wholesale power prices up, which increases gas-fired generation, which increases demand and market prices for gas, etc., but also because end-users can to some extent substitute gas for electricity and vice versa if their prices get too far out of line), we would expect -- and presumably promoters of gas-fired merchant plants expect -- gas-fired power generation to remain profitable over the long term.

On the other hand, other factors must not be ignored. Merchant plant operators are interested in hedging risk and, of course, price volatility contributes to an increase of the risk that must be hedged and the consequent cost. There is also concern by some that high gas prices and resulting electrical prices may suppress power demand in supply situations where greater price elasticity prevails.

Re: UDC Contact Limits

For reasons previously explained, the Cooperatives urge the Commission to take no action which would imperil all requirements or partial requirements contracts among AEPCO and its member distribution cooperatives. They assure both continued rate stability and future financing security.

Re: Replacement of older plants:

We believe no regulatory provisions are necessary to replace older plants with newer ones. This is because that process will happen on its own.. A great number of plants currently in use are more than 30 years old. They will, over the next few years, require major replacements (which may trigger environmental permitting consequences) to remain useful for any role other than emergency backup or occasional peaking. Consequently, they will be decommissioned as economics dictate.

Re: Pricing:

Transmission is ordinarily some 12 percent of the price charged an end use consumer (it is roughly 25 percent of a wholesale sale delivered to a distribution delivery point). The majority of generation used in Arizona will continue to come from generation located in Arizona. At a minimum, the projected annual O&M costs of an RTO will add \$1 per MWH to the cost of power. That's roughly five percent at today's wholesale cost. Is an

RTO which essentially duplicates current operations the answer to lower prices? That analysis has never been made. Consequently, we do not yet know if RTO's are the answer for end-use consumers.

10421-0031/995472v1



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
PUBLIC UTILITY REGULATION

July 27, 2001

Robert D. Rosenberg, Esq.
Slover & Loftus
1224 Seventeenth Street, N.W.
Washington, DC 20036

Re: Arizona Electric Power Cooperative
File No. 132-3

Dear Mr. Rosenberg:

Enclosed is our response to your letter of July 26, 2001. By incorporating our answer in the enclosed copy of your letter, we avoid having to recite or summarize the facts involved.

Very truly yours,

A handwritten signature in cursive script that reads "David G. LaRoche".

David G. LaRoche
Special Counsel

Enclosure

RESPONSE OF THE OFFICE OF
PUBLIC UTILITY REGULATIONOur Ref. No. 01-2-OPUR
Arizona Electric Power
Cooperative, Et Al.DIVISION OF INVESTMENT MANAGEMENTFile No. 132-3

Without necessarily agreeing with your legal analysis, and subject to the limitations set forth in the paragraph below, based on the facts and representations in your letter of July 26, 2001, we would not recommend any enforcement action to the Commission under section 2(a)(7) of the Public Utility Holding Company Act of 1935 against any Member, as defined in your letter, of Arizona Electric Power Cooperative ("AEPCO") or any Member of its restructured progeny, GENCO, TRANSCO and CSP, if the proposed restructuring of AEPCO takes place in the manner and under the circumstances described in your letter.

You should note that facts or conditions different from those presented in your letter might require a different conclusion. Further, this response expresses only the Division's position on enforcement action. It does not purport to express any legal conclusion on the questions presented. Finally, you should note that the relief provided by this response applies only to the specific Class A, B and C Members identified by name in your letter. It does not extend to any new Members of these three Classes or to the members of any new membership classes which may be added in the future.

David G. LaRoche
Special Counsel

July 27, 2001