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AZ CORP COMMISSION
DOCUMENT CONTROL

Nancy Cole, Supervisor
Docket Control
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Re: In the Matter of the Generic Proceedings Concerning Electric Restructuring Issue (Docket No. E-00000A-02-0051)

Dear Ms. Cole:

Enclosed for filing in the above-referenced proceeding are the original and ten (10) copies of the responses of Sempra Energy Resources to certain of the questions which have been posed by Chairman Mundell and Commissioner Spitzer.

Please let me know in the event you have any questions.

Sincerely,

Lawrence V. Robertson, Jr.

Lawrence V. Robertson, Jr.

Arizona Corporation Commission
DOCKETED
FEB 25 2002
DOCKETED BY

cc: All parties of record
Ted Roberts

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RESPONSES OF SEMPRA ENERGY RESOURCES

TO COMMISSIONER MUNDELL JANUARY 14, 2002 QUESTIONS

Sempra Energy Resources is pleased to offer its comments in response to the questions posed by Commissioner Mundell. Sempra Energy Resources is a wholesale power provider and owner of the 1000 MW Mesquite Generating Station now under construction at the wholesale market center at Palo Verde, Arizona. As a competitive wholesale power supplier we have directed our responses primarily those questions that refer to competitive wholesale power market in Arizona. It has been demonstrated in California and elsewhere that a robust wholesale power market is a necessary condition for a successful retail power market. We believe that the rulemaking that the Arizona Corporation Commission (ACC) has in place will continue to foster a robust wholesale market. In response to these rules Sempra Energy Resources has undertaken the construction of the Mesquite Generating Station and is committed to be an active participant in the Arizona market. We turn now to our responses to 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 nonfirm power; long- and short-term contracts; backup and coordination services:

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:

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.

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

1. What are the potential price benefits?

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

3. What are the potential non-price benefits?

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

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?

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
Not applicable to wholesale.

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

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

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

3. Are there technical, legal, or other barriers to entry in the [*wholesale*] markets? For example:

a. Are there legal or technical barriers to the construction of the different types of generation plants by non-utilities?

Response
Non-utilities or independent power producers like Sempra Energy Resources, face the same environmental, technical, and institutional constraints faced by a regulated utility or a subsidiary of a regulated utility for the construction of new generating plant in Arizona. The rules put in place by the ACC, state and federal environmental agencies,

water agencies, and land use agencies do not distinguish between non-utilities and utilities in regard to the approval of the construction and operation of generating facilities. In fact many of the rules and regulations now in place in Arizona and elsewhere encourage the construction and ownership of new generation by non-utilities.

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
At the wholesale level, Sempra Energy Resources before committing to its construction program in Arizona determined that the costs referred to were sufficiently small relative to the expected revenues under the assumption that the competitive wholesale market rules established by the ACC would stay in place. That is after 2003, one-half of the default power supply would be purchased in the competitive wholesale market.

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 that provide the service subject to reliability and safety rules?

Response
As stated in our response to3a above, at the wholesale level all suppliers, non-utility and utility, are subject to the same safety rules. A non-utility wholesale power supplier has a special incentive to supply a reliable source of power for only in this way can the non-utility wholesale power supplier sell product and derive earnings therefrom.

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?

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
The rules established by the ACC and Federal regulation have been strongly encouraging wholesale competition. The ACC's requirement for competitive bidding for one-half of the energy supply to be obtained by the retail provider of last resort (POLR) has dramatically facilitated the entry of new wholesale power providers in Arizona.

Wholesale electric power competition was also encouraged at the Federal level with the passage of the Energy Policy Act of 1992 (EPA-92). This legislation removed independent power producers from the ownership restrictions of the Public Utility Holding Company Act of 1935 and provided FERC with explicit authority to order transmission access and wheeling. This action significantly altered the status quo and has had widespread implications throughout the electric utility industry. One of the key elements of a robust wholesale market is access to transmission.

In April 1996, the FERC issued two long-awaited rules, 888 and 889. These rules implemented EPA-92's provisions for open access to transmission lines. Rule 888 addresses equal access to the transmission grid for all wholesale buyers and sellers, transmission pricing, and the recovery of "stranded costs." Transmission owners must now offer transmission services to all power suppliers, including non-utility suppliers, who desire to use those facilities. Transmission services must be offered under equal prices, terms, and conditions to all users, including the transmission owner. This means that no transmission user has a competitive advantage over another because of a unique ability to use or pay for transmission services. Rule 888 requires jurisdictional electric utilities that own or operate transmission facilities to establish electronic systems to post information about their available transmission capabilities. In response to these two rules, many electric utilities are forming Independent System Operators (ISO) to operate the transmission grid, regional transmission groups, and open access same-time information systems (OASIS) to inform transmission users of available capacity on their lines.[1] *The ISO controls and operates the grid, without regard to ownership of the grid.*

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

Response

The key risk(s) that must be considered are price level and price volatility. Competitive bidding will establish the proper price level. In this way, only the low cost producers will enjoy success in the bidding process. As stated earlier, the ACC's competitive bidding rules have encouraged additional generation suppliers to come into the state to compete with the incumbent utilities. This additional capacity will promote competition and keep the risk of price increases down. Price stability will be offered through long-term contracts (in contrast to the spot market). Prices offered by the competitive wholesale power suppliers can be hedged with various financial instruments to protect the prices offered. These benefits will, of course, ultimately result in lower prices to retail consumers who remain with the provider of last resort. In addition, if for some reason the demand for electricity did not meet expectations in the future, it is the independent power producer that would take the risk of fewer sales. The retail consumer would be insulated from power supply risks.

[1] Energy Information Administration/Electric Sales and Revenue 1996, op. cit., p. 4.

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?

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?

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

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?

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?

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

Purchases need not be limited to non-affiliates. As long as the ACC has affiliate rules in place that require the utilities not to favor their affiliates, but truly operate in an open competitive market there is no reason why the affiliate cannot be a bidder as well.

2. Are utilities taking steps that will make competition more difficult down the road (e.g. retail marketing, internal restructuring, entering into agreement to avoid customer self generation)? If so, identify those steps and how the Commission should respond.

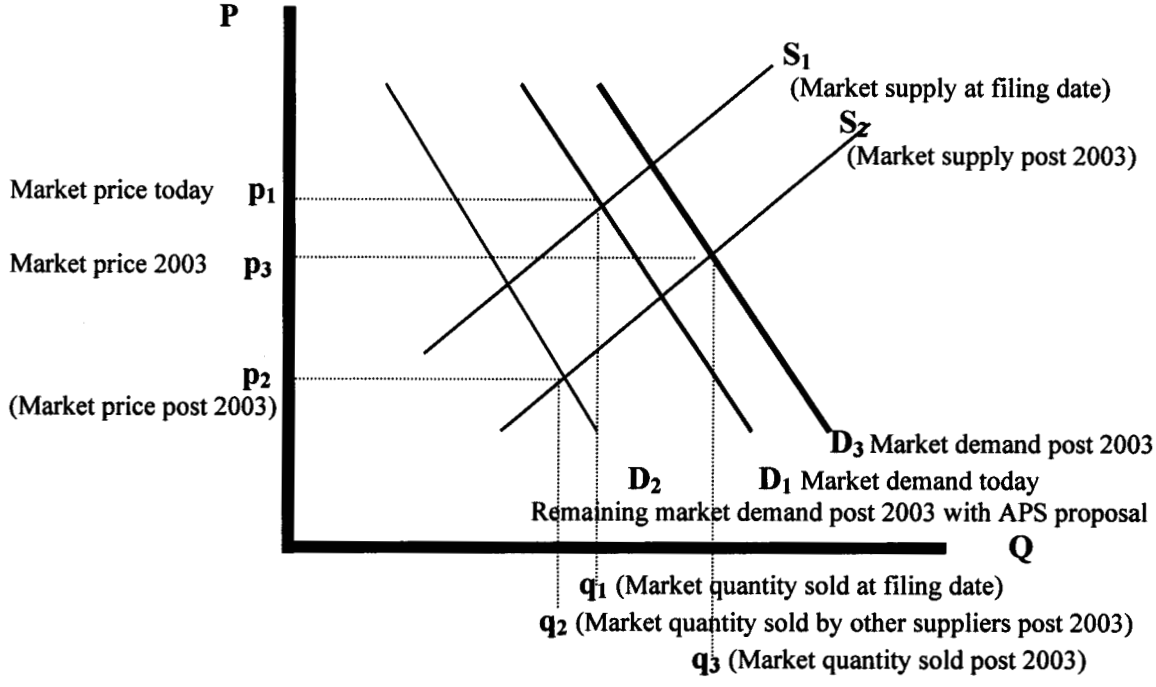
Response

Even though this question is retail it addresses a wholesale issue as well. Arizona Public Service (APS) seeks a variance to wholesale bulk power competition through its proposed purchases from its wholly owned subsidiary. If the ACC approves the variance APS will be allowed to purchase all their power from their parent company, Pinnacle West, until 2015 instead of 50% from the competitive wholesale market as with the current regulations. Contrary to APS's filing, competition is growing in the Arizona with several

new plants under construction. (There are 69,313 MW of capacity now under construction in the WSCC area). APS appears to be trying to lock in some (high) prices before this competition hits.

The anti-competitive affect of APS's action and its harmful results on the consumer is shown in the figure below.

Figure 1
Affect of the APS Proposal on Market Prices



In Figure 1 the supply of energy in the wholesale bulk power market and the demand for energy is shown. Note that supply curve S shifts to the right (from S_1 to S_2) after 2003 as new generation in the region comes on line. D_1 is the demand for energy at the filing date (October 2001). D_2 depicts the demand for energy in the post 2003 period seen by suppliers other than APS if the APS proposal is approved by the ACC. That is the difference in quantity (q_1 - q_2) is the amount of energy locked in at price p_1 by APS if the filing is approved by the ACC. The price p_2 is the result of an increase in supply in the market after 2003 with the APS proposal. This price may be too low for new suppliers to serve this market. Thus, APS customers are left with higher than market prices if APS is successful in its request for a variance. However price p_3 is the price faced by ALL market participants after 2003 if the APS proposal is NOT accepted by the ACC. This price p_3 is lower than price p_1 yet sufficiently above price p_2 to sustain a robust competitive wholesale market. This is the best result because now all customers can share in competitive market prices. In contrast, APS has requested approval of a cost based contract at the price p_1 for its newly constructed Red Hawk 1 and 2 generation plants. This is unfair to potential competitors and results in higher prices to consumers.

Therefore, the ACC should deny the ACC's variance request. And stay the course with the rulemaking that it has already approved. If the variance request proposal is granted, standard offer customers will be worse off.

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?

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

IV. Retail Generation Competition

A. Regarding each identifiable generation product-

1. Identify with particularity any defects in the wholesale market structure affecting Arizona.

Response:
The benefits available to customers by obtaining power from alternative suppliers is dependent upon sufficient transmission capacity. The ACC's approval of the West Valley transmission line has helped to make the competitive wholesale market possible. The continued support of the ACC for transmission upgrades will sustain the market conditions necessary for both wholesale and retail competition. In this regard APS should be encouraged to continue to build and maintain a world class transmission (and distribution) system to keep the benefits of wholesale and retail competition flowing to the retail consumers of Arizona.

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

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

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

Response
Yes. New generation now under construction in Arizona has a lower heat rate than older units, thus operating with less fuel per kWh produced. This enables new generation not only to compete in price with older generation, but to do so in a more environmentally benign manner.

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

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 seasons of the year or times of the day?

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

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

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

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.

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?

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

8. Does the transmission and distribution system facilitate or deter-

a. the development of renewable energy technologies?

b. the development of distributed generation?

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

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:

a. How would retail customers be affected?

Response
As demonstrated in our previous responses, without competitive bidding, retail customers will likely pay more for electricity than they would with competitive bidding. Please refer back to Figure 1 on page 6 and the explanation that follows.

b. How would retail generation competition be affected?

c. How would wholesale generation competition be affected?

Response
Adversely. Construction of additional generation may be deferred or canceled altogether which can lead to higher prices and market price volatility.

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

Response
Yes. As additional generation comes on line and competitive wholesale prices continue to fall, a higher percentage could be justified. The ACC may wish to revisit this issue on an on-going basis.

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?

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.

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?

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?

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.)

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

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.

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?

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.

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

Response

The market structure that the ACC has already adopted for Arizona is the correct choice. Restructuring in California, from the outset, followed a path markedly different from that followed in Arizona and elsewhere. The California structure was characterized, among other things, by separate responsibility for forward markets on the one hand and for real-time markets and transmission service on the other; by an imprecise zonal pricing system; and by retail rate caps that effectively prevented consumers from taking steps to curtail electric demand when prices are high.

The operation of the California Power Exchange (Cal-PX) substantially contributed to the much-publicized problems in the state. The major regulated electric utilities, PG&E, SCE and SDG&E were required to purchase most of their electricity from the Cal-PX. Many sellers offered electricity to the Cal-PX in the day-ahead market on an hourly basis, with the price for each hour set by the highest price bid. This is known as the single auction process and is illustrated in Table 1:

Table 1
The One Price Market

Hypothetical Half Hour Time Period	*Megawatts Offered*	*Price Bid/MWh*	*Price Paid/MWh*
Supplier A	*20,000*	*$ 75*	*$ 250*
Supplier B	*5,000*	*$ 118*	*$ 250*
Supplier C	*1,000*	*$ 250*	*$ 250*
Total	*26,000*	*$ 90 average*	*$ 250*

With this single auction process, even though a supplier or generation provider may be willing to sell electricity at a relatively low price, all suppliers are paid the same price (which is the highest price accepted) for the hour. The result is a market where there is no true supplier-on-supplier competition, a situation that cannot possibly lead to lower prices. In effect, the Cal-PX had replaced multiple suppliers with essentially one supplier with monopolistic market power. While the single auction process may work well in a market with excess supply, it breaks down when supply and demand reach a closer balance. A further consequence of the operation of the Cal-PX is that it precluded the development of a bilateral contract market. By the Cal-PX setting the price for the vast majority of power sold in the state, to enter a bilateral contract a seller would seek a premium to that price while a buyer would desire a discount. The end result was that few of the financial products or tools that would have mitigated price volatility were applied in the California market.

Further compounding the problem were two other factors. First, PG&E, SCE and SDG&E were required by the California Public Utilities Commission (CPUC) to purchase most of their electricity from the Cal-PX at the Cal-PX price. Thus, the price buffering associated with longer term and/or fixed price agreements was unavailable to them. Also contributing to California's problems were the on again off again price caps imposed by the Cal-ISO that created a real-time shortage environment. As mentioned above, the regional supply and demand for electricity are closely matched. When equipment malfunctions or other circumstances (such as an understated day-ahead forecast by the Cal-ISO) resulted in the need for more real time electricity, the cap drove electricity out of California, to all other states in the region where no caps existed.

Although the Cal-PX was originally expected to encourage bids from generators at their marginal cost, it resulted in generators being paid well above their marginal cost. This effect (as shown in the bottom line of Table 1) saddled the utilities with hundreds of millions, and perhaps billions, of dollars of excess purchased power costs.

Thus, the prices in the California market were not really "market prices" due to the existence of a price cap, few bilateral contracts, lack of a functioning forward market, the requirement to purchase power almost exclusively from the Cal-PX with its single auction process. A true market price will result only if many competitors are permitted to not only offer real time and long-term pricing options, but also permitted offer financial products in the futures market to mitigate price risk.

Other factors that contributed to the problem included:

- *The utilities were required to sell generation while maintaining supplier of last resort status;*
- *Utilities were forbidden to sign long-term power supply contracts;*
- *Retail rate caps without wholesale rate caps;*
- *High competition transition charges;*
- *Lack of interest by consumers and alternative suppliers;*
- *High natural gas prices; and*
- *Low hydro generation.*

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

Response

No. The Enron bankruptcy was an accounting/ off balance sheet issue. It is important to keep in mind that Enron was the messenger, not the message. Wholesale and retail electricity markets are likely to continue to develop. As noted by Pat Wood, FERC Chairman, "Enron is a human tragedy, but it is not an impediment to transparent power markets. In fact it makes the case to hasten their day." Nora Brownell, a FERC commissioner, added that Enron's financial troubles were related to the company's accounting procedures and not wholesale energy markets. "Actually, the markets worked quite well. There was little volatility even after the EnronOnline screens went blank," she said. "Other traders have stepped into the void created so that trading is going on. There is liquidity in the market."[2]

We agree with Commissioners Wood and Brownell, the Enron bankruptcy has had no effect on the competition in the wholesale markets.

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

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.

[2] Kenneth Betz, "Enron's Abrupt Crash and Burn Stuns Energy Markets," Energy User News, December 19, 2001, p. 2.

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.

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

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

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

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

F. Provide specific examples to support your answers.

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.

RESPONSES OF SEMPRA ENERGY RESOURCES

TO COMMISSIONER SPITZER JANUARY 22, 2002 QUESTIONS

Sempra Energy Resources is pleased to offer its comments in response to the questions posed by Commissioner Spitzer. Sempra Energy Resources is a wholesale power provider and owner of the 1000 MW Mesquite Generating Station now under construction at the wholesale market center at Palo Verde, Arizona. As a competitive wholesale power supplier we have directed our responses primarily only to those questions that refer to competitive wholesale power market in Arizona. It has been demonstrated in California and elsewhere that a robust wholesale power market is a necessary condition for a successful retail power market. We believe that the rulemaking that the Arizona Corporation Commission (ACC) has in place will continue to foster a robust wholesale market. In response to these rules Sempra Energy Resources has undertaken the construction of the Mesquite Generating Station and is committed to be an active participant in the Arizona market. We turn now to our responses to 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?**

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

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

Response:
The incentives or disincentives a vertically-integrated utility has to provide renewable power are dependent on the regulatory parameters in which the utility operates. Some of the same mechanisms that are available to encourage renewable power in a competitive market are available to encourage renewable power under a vertically-integrated utility model, such as a renewable portfolio requirement or a generation performance requirement.

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

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

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

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?

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

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

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?

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

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

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 place on a CEC since Arizona's adoption of a de-regulated utility model?

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

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

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

RESPONSES OF SEMPRA ENERGY RESOURCES

TO COMMISSIONER IRVIN FEBRUARY 7, 2002 QUESTIONS

Sempra Energy Resources is pleased to offer its comments in response to the questions posed by Commissioner Irvin. Sempra Energy Resources is a wholesale power provider and owner of the 1000 MW Mesquite Generating Station now under construction at the wholesale market center at Palo Verde, Arizona. As a competitive wholesale power supplier we have directed our responses primarily only to those questions that refer to competitive wholesale power market in Arizona. It has been demonstrated in California and elsewhere that a robust wholesale power market is a necessary condition for a successful retail power market. We believe that the rulemaking that the Arizona Corporation Commission (ACC) has in place will continue to foster a robust wholesale market. In response to these rules Sempra Energy Resources has undertaken the construction of the Mesquite Generating Station and is committed to be an active participant in the Arizona market. We turn now to our responses to Commissioner Irvin's questions.

1. If the majority of market participants intend to market electricity only to industrial, large commercial and load serving ESP entities, should retail markets be limited by load size to allow those entities with true bargaining power negotiate Direct Access?

2. What will be a UDCs primary functions in a competitive market?

3. **Is it important to first establish functional wholesale markets before creating robust retail markets in electric generation? If so, why?**

   Response
   A robust competitive wholesale market is critical for retail competition as California's dysfunctional and immature wholesale market clearly demonstrated. The rulemaking that the ACC has already adopted for Arizona will avoid California's limitations. Thus, the establishment of a functional wholesale market is well underway in Arizona. First, significant new supply is under construction to support wholesale competition. Second, the state's incumbent transmission owners have filed with FERC a request for West Connect to conform to its RTO requirements. In addition, transmission access by all suppliers is critical to the development of a robust market along with the construction of new transmission to eliminate bottlenecks.

4. **When price caps are lifted for the majority of Arizona consumers, what assurances do we have volatility in the market (for both natural gas and**

electricity) will not result in unstable or inflated rates? Will the generation price of electricity fluctuate with the price of natural gas?

Response

Fortunately, the ACC has already established the ground rules for a robust competitive wholesale market. If the incumbent Arizona utilities competitively bid as required, they will have the opportunity to receive attractive offers for power deliveries for long-term periods (e.g., 10, 15 or even 20 years or more) thus mitigating price volatility. With the merchant plants already under construction in Arizona, the incumbent utilities will enjoy a "buyers market" for the relatively foreseen future and will be able to lock in prices very favorable for retail consumers.

Fluctuating gas prices can be hedged or mitigated with long term contracts. In addition, the competitive bidding process will allow suppliers to hedge gas supplies for the future sales that they have successfully marketed. Thus, any uncertainty in future gas prices should not be an issue in the Arizona market.

5. Should there be a provision added to R14-2-1606(B) which would allow/limit a UDC to for wholesale power in three or five year intervals? What would be a proper length for contracts?

6. What are the real benefits to residential customers and small business in retail competition other than consumer choice? Will IPPs market their power directly to retail customers, or are their efforts mainly focused on selling power to wholesale customers?

7. Currently, is residential choice a real option? If not now, when?

8. **What provisions, if any, are necessary to effectuate a gradual replacement of those existing plants in Arizona which are older, more polluting and less efficient than the newer combined cycle plants currently being built?**

The older, more polluting plants in Arizona are operated during peak periods primarily because of transmission constraints into Phoenix. As these constraints are eliminated, these plants will no longer be necessary and the economics of running these plants will force them to be closed.

9. **What are the long-term effects of divestiture for APS? How does the Commission guard against a PG&E situation, where the distribution company declares bankruptcy after profits have flowed to its parent holding company?**

The PG&E bankruptcy was caused by retail price caps that did not allow the utility to flow through increasing wholesale spot market purchased power costs to consumers. With the market structure the ACC now has in place, competitive bidding will alert the

ACC to a possible shortfall and allow time to prevent flowing through profits until the shortfall is corrected.