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February 25, 2002

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Arizona Corporation Commission
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FEB 25 2002

Chairman William A. Mundell
Commissioner James Irvin
Commissioner Marc Spitzer
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007

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**Re: Electric Competition Rules, Docket No. RE-00000C-00-0275
AISA, Docket No. E-00000A-01-0630
APS Request For A Variance, Docket No. E-01345A-01-0822
Generic Docket for Electric Restructuring, Docket No. E-00000A-02-0051**

Dear Chairman Mundell and Commissioners Irvin and Spitzer:

Panda Gila River, Limited Partnership ("PGR") is grateful for the opportunity to respond to your recent letters and questions regarding the status of electric restructuring in Arizona. The PGR project, a partnership between Panda Energy and TECO Power Services, is a 2,300 megawatt state-of-the art, natural gas-fired power plant under construction in Gila Bend, Arizona that is scheduled for commercial operation next year.

We look forward to serving Arizona's native load with a reliable, cleaner, more-efficient, and less-costly alternative power product, and we applaud the Arizona Corporation Commission for its wisdom in establishing a well-thought out competitive model over the past several years. Indeed, Arizona's restructuring model was a major reason for PGR's decision to invest over \$1 billion in this state. In that regard, it is worth restating that Arizona Public Service Company's ("APS") and Tucson Electric Power Company's ("TEP") pending requests for variances of the Electric Competition Rules, which would delay or permanently hobble competition in the state, are squarely at odds with both this Commission's vision and with the legitimate investment expectation of both PGR and other competitors in Arizona's wholesale and retail markets.

PGR will be a wholesale provider of electricity, and will not sell at retail. For that reason, we have concentrated on those questions addressing wholesale competition issues, and have in some instances declined to answer certain questions about Arizona's retail restructuring. We wholeheartedly agree with Commissioner Irvin's observation at the procedural conference regarding APS' request for a variance, that retail competition in the electric market will succeed only if there is a vibrant and competitive wholesale market. If the Commission, by action or inaction, forecloses the benefits of wholesale competition by allowing incumbents to retain their market power in generation and transmission in the state, all Arizonans will suffer.

The Commission long ago recognized that a robust wholesale market was essential for a competitive retail market, and accordingly required incumbent utilities to purchase power needed to serve Standard Offer customers on the open market to further the public interest. In so doing, the Commission ensured that competitive wholesale generators would have a market for their generation, and ensured that consumers would benefit from the availability of lower-cost, reliable power. In addition, by requiring at least half of this power to be purchased through a competitive bidding process and all of the power to be secured through transactions negotiated at arm's-length, the Commission limited the opportunities for incumbent utilities to exercise their market power by dealing only with their affiliates.

The Commission's vision for competitive wholesale and retail electricity markets will only be possible if the framework established in the Electric Competition Rules and 1999 Settlement Agreements is maintained. If the Commission does not take action to ensure that the competitive bidding process and bilateral contract negotiations are concluded by the end of 2002, a robust wholesale market will be imperiled, putting any future retail market at risk. If the Commission further allows incumbent utilities to exercise and abuse their existing market power in generation, transmission and distribution markets, the viability of the wholesale power market will be threatened.

The APS variance request is a case in point. Allowing APS to derail the competitive bidding process by dealing exclusively with its generation affiliate will eviscerate the wholesale and retail market for the foreseeable future by eliminating competition. Competitors like PGR are ready to supply low-cost power for the state's Standard Offer customers at better terms and conditions than APS's proposed contract with its affiliate. PGR will provide the same guarantees of reliability that Pinnacle West proposes to provide to its affiliate, ensuring that retail customers will not be put at risk.

While transmission constraints are a concern throughout the West, claims that utilities should be able to eliminate competitors in the wholesale market because the competitors would not be able to obtain transmission to serve wholesale and/or retail customers are groundless and potentially illegal. Competitive generators would have the same transmission priority in serving Standard Offer customers that APS' affiliate does – the same transmission capacity currently reserved for and used by APS to serve its native load would be available to competitors once APS no longer was directly responsible for supplying power to those customers.

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Comparisons of the Arizona market to the flawed market in California are similarly groundless. By denying retail electric providers the opportunity to enter into a prudent mix, various length-forward contracts, the California restructuring plan exposed consumers to the price volatility of the spot market without a primary means to hedge against that volatility. Under the Arizona Competition Rules, on the other hand, the existing utilities will purchase power for Standard Offer customers under competitively-priced, arm's-length negotiated contracts, avoiding the problems that plagued the California wholesale markets.

As a competitive wholesale electric market already exists in Arizona, and as generators stand ready to supply competitively-priced, reliable power for Standard Offer customers in the future, the Commission should continue to implement the Competition Rules. The Commission should reject APS' and TEP's requests for a "variance" from the Rules and the 1999 Settlement Agreement, and should require the companies to issue an RFP for the supply of power for their Standard Offer customers and immediately begin negotiations for bilateral, arm's-length contracts to supply power not obtained through this RFP process.

We thank you again for the opportunity to respond to your questions. If you have any questions regarding the matters discussed above or the attached answers, please contact the undersigned.

Sincerely,

FENNEMORE CRAIG



C. Webb Crockett

Jay L. Shapiro

Attorneys for Panda Gila River L.P.

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PANDA GILA RIVER, LP'S
RESPONSES TO
CHAIRMAN MUNDELL'S QUESTIONS
DATED JANUARY 14, 2002

PANDA GILA RIVER, LP
DOCKET NOS. RE-00000C-00-0275;
E-00000A-01-0630; E-01345-A-01-0822;
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CHAIRMAN MUNDELL'S QUESTIONS
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1. 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.

Answer: Generation and retail aggregation of loads are goods and services traditionally provided by the electric utility for which competition is possible. Wholesale generation, including baseload, intermediate and peaking power provided through firm and non-firm, long, intermediate, and short-term contracts, enables the ultimate retail customers to receive reliable energy at competitive prices. As outlined in the Arizona Corporation Commission's ("ACC" or "Commission") Electric Competition Rules A.A.C. R14-2-1601, et seq. (the "Rules"), the Commission specifically established a framework for introducing competitive electric services. This framework foresaw that many public interest benefits, including significant rate reductions, could be achieved by enabling new entrants to compete within the Arizona electric market on a level playing field. Development of a viable wholesale competitive market is a necessary first step in the Commission's objective of retail access for Arizona's retail and wholesale ratepayers.

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1.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?

Answer: The possible benefits of competition for wholesale generation include safe, reliable and competitively-priced electricity. In accordance with Rule 1606, each utility distribution company is required to acquire power from the competitive market through prudent, arm's-length transactions, with at least 50% of their standard offer requirements acquired through a competitive bid process. This envisions a mechanism to ensure that purchased power transactions negotiated on behalf of standard offer customers are competitively priced, and offer reliable service. A truly competitive market structure such as the one contemplated by Rule 1606 allows new service providers to enter local electric power markets and compete for wholesale customers. This enables wholesale customers to choose from different potential suppliers, which will lead to lower overall rates with the same, if not higher, quality levels of service.

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

Answer: The price benefits due to competition in the wholesale generation markets will begin on "day-one". In fact, the negotiated settlements have already provide nominal and real rate reductions for the ratepayers of Arizona, which makes this state atypical within the West region over the last two years.

In addition, as of the end of 2001, over 21,000 MW (see details in response to question 2.B.1.) of planned or under-construction, merchant capacity had been announced to Arizona over the next eight years. Given that Arizona's current demand is estimated to be approximately 14,000 MW, the state is already postured to have a vibrant wholesale market in-place next year and throughout the long-term. Under Rule 1606, utility distribution companies will acquire capacity through competitively-bid or negotiated, arms-length, bilateral contracts. The utility must then demonstrate to the Commission that its contracting processes were followed consistently and have led to the lowest, most-prudent rates for its standard-offer customers on a going-forward basis.

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3. What are the potential non-price benefits?

Answer: The potential non-price benefits from competition in wholesale generation include newly constructed, state-of-the-art, increasingly fuel-efficient, and reliable generation resources. These new competitive generation resources will enhance Arizona's air quality, while reducing the all-in costs to the state's ultimate consumers.

Other potential benefits due to wholesale competition include improved reliability from a more-liquid, competitive marketplace for power. This improved reliability would come from contractual performance obligations on the part of the generators. Reliable electric service, which is also an objective of all jurisdictional electric utilities, is more likely under contractual arms-length negotiated, purchased power agreements between the utility distribution companies and unaffiliated merchant generators, which include incentives for the supplier to meet specific availability guarantees and penalize non-performance.

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

Answer: In addition to the response to B.3. above, the entry of new wholesale generation investments in the state leads to enhanced economic development opportunities. For example, a sufficient supply of competitively-priced, reliable energy resources attracts new commercial enterprises to the state that are electricity-intensive. In addition, it helps the state's public and private economic development authorities to retain existing entities and/or support their expansion. As new businesses are allowed to enter, compete and expand in Arizona, new jobs are created directly and indirectly. This is a particular positive for the state's more rural regions, such as southwestern Maricopa County, where Panda Gila River (PGR) will locate, that struggle to attract industries when they do not enjoy the inherent natural advantages of location, raw materials, etc.

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2. 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?

Answer: PGR believes that competitive markets will exist for the wholesale generation and ancillary service products required to serve Arizona's market. Wholesale generation (i.e. energy and capacity) and certain ancillary services (i.e. operating reserves, regulation, frequency response service and energy imbalance service) are products for which competitive markets can and will exist in the context of Arizona's marketplace.

As detailed in PGR's response to Question 2.B.2., over one dozen new market entrants are adding generation capacity within Arizona that totals over 21,000 MW. All of these new resources will be able to provide these wholesale generation and ancillary service products. Furthermore, Arizona's wholesale market is geographically located near two of the most active trading hubs in the desert Southwest – Palo Verde and Meade. Thus, these products can be supplied not only by resource owners within Arizona, but also by competitors from the entire Southwest market.

The key to success is an open, transparent wholesale market for Arizona that allows non-discriminatory, open access to the transmission system, permitting all potential suppliers of wholesale products, including affiliates of the incumbent utilities, to compete on a level playing field.

Notwithstanding the above discussion, PGR also recognizes that the market within Arizona has several major load pockets caused by limited transmission capacity. These transmission constraints will cause the need for Must-Run Generation facilities during certain operating conditions. The Commission has recognized this issue as well and has implemented certain provisions to deal with Must-Run Generation in its Rules.

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2.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 competitors will actually be interested in providing?

Answer: Yes. In fact, competitors already have signaled their belief that Arizona would be an attractive marketplace, as evidenced by the number of viable projects already being developed. The attached table lists the current merchant power plant projects planned or under development within Arizona as of December 14, 2001.¹ These projects represent over 21,000 MW of potential capacity valued at over \$7.2 billion of combined investment. Moreover, there are over a dozen different firms representing a number of new potential competitors responsible for these projects.

¹ Source: ACC website.

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Arizona Merchant Plant Development – As of December 14, 2001							
<u>Company</u>	<u>Type of Plant</u>	<u>Capacity (MW)</u>	<u>City</u>	<u>State</u>	<u>Status</u>	<u>Production Date</u>	<u>Cost</u>
PP&L Global/Duke Energy	Gas	520	Kingman	AZ	Under Construction		\$ 275,000,000
Salt River Project	Gas	825	Gilbert	AZ	Planned		\$ 400,000,000
Pinnacle West Energy	Gas	2,120	Arlington Valley	AZ	Planned	2003	\$ 1,000,000,000
Duke Energy	Gas	550	Arlington Valley	AZ	Planned	late-03	\$ 250,000,000
Power Development Enterprises	Gas	750	Gila Bend	AZ	Planned	early-04	\$ 400,000,000
SRP/Dynergy/NRG Energy	Gas	825	Tempe	AZ	Planned	mid-02	\$ 400,000,000
Panda Energy/TECO Power Services*	Gas	2,300	Gila Bend	AZ	Under Construction	2003	\$ 1,000,000,000
Calpine/Pinnacle West	Gas	545	Phoenix	AZ	In Commercial Operation		\$ 220,000,000
Reliant Energy	Gas	550	Casa Grande	AZ	Under Construction		\$ 263,000,000
Allegheny Energy	Gas	1,080	La Paz County	AZ	Planned	2005	\$ 540,000,000
Reliant Energy	Gas	500	Las Vegas	AZ	Planned	Jun-03	\$ 270,000,000
Southwestern Power	Gas	1,800	Eloy	AZ	Planned	2004	\$ 1,000,000,000
Pinnacle West Energy	Gas	2,120	Palo Verde	AZ	Under Construction	2002	\$ -
PPL Global	Gas	600	Pinal County	AZ	Planned	2002	\$ -
Sempra	Gas	1,000	Maricopa County	AZ	Planned	2003	\$ 600,000,000
Unisource/Bechtel	Coal	760		AZ	Planned	2005	\$ -
Southwestern Power	Gas	1,000	Cochise County	AZ	Planned	2004	\$ -
PG&E Generating	Gas	1,040	Harquahala Valley	AZ	Under Construction	mid-03	\$ 400,000,000
Calpine Corp.	Gas	526	Bullhead City	AZ	In Commercial Operation		\$ 275,000,000
Reliant Energy	Gas	580	Pinal County	AZ	Planned	2004	\$ -
Reliant Energy	Gas	580	Pinal County	AZ	Planned	2009	\$ -
Salt River Project/UniSource	Coal	760	Springerville	AZ	Planned	2005	\$ -

*Currently, PGR is under construction.

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

Answer: As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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?
 - 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?

Answer: Assuming no rollback in the Rules and given the potential generation investment in Arizona referenced above, there does not appear to be any significant technical, legal or other prohibitive barriers to constructing new generation facilities in the state. However, ensuring open, transparent access to the existing and future transmission system, with equivalent treatment for all market participants, is a necessary component of Arizona's energy market.

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- 2.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?

Answer: No. These products and services are, in fact, being provided by multiple parties today. For example, Arizona's incumbent utilities regularly buy and sell wholesale energy and reserve products with many parties, within and outside of the state of Arizona, and coordinate the delivery of these products on an hour-by-hour basis. There are pre-existing scheduling and operating procedures in place that allow these multi-party transactions to occur, while maintaining the overall security of the transmission system. Furthermore, there is ample experience in many other jurisdictions throughout the country where the statewide and regional transmission systems are being operated in a reliable and safe manner within the context of multiple suppliers. The reliability and safety of the system will not be jeopardized by allowing multiple parties to provide the competitive wholesale products described in Question 1.

The principle of requiring competing suppliers to accept and operate within an agreed-upon set of operating rules and procedures is critical to ensuring the reliable and safe operation of the transmission system. The critical difference from the existing arrangements today, however, will be the entity going-forward that administers these operating procedures. Within a competitive market, these operating rules must be applied on a non-discriminatory basis by an entity that does not have a bias for or against any competitive supplier. Thus, these rules must be administered by an independent entity, so that all market participants are treated equally, and the system is operated in a reliable and safe manner for the retail consumers of the state.

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2.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?

Answer: As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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3. 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?

Answer: The Rules are a crucial component in the transition to a competitive electric generation market. Overall, the framework created by the Rules fosters competition on both the retail and wholesale levels. One of the most important sections of the Rules in ensuring a viable competitive wholesale generation market is Rule 1606(B). Rule 1606(B) provides that power purchased by an incumbent utility for standard offer service must be acquired from the competitive market through prudent, arms-length transactions, and with at least 50% of the requirements secured through a competitive bid process.

A number of competitive wholesale generators are developing or constructing new generation facilities within the State, relying on the requirement of Rule 1606(B) that the State's incumbent providers are required to acquire 100% of the power they require for standard offer service. Removing this requirement would undermine the incentive for competitive wholesale generators to provide much needed power in Arizona. Moreover, a robust competitive wholesale market will result in lower generation prices for standard offer customers as well as competitive retail customers.

The current federal regulatory regime seeks to foster wholesale competition by ensuring that transmission providers treat non-utility suppliers comparably to how those transmission providers would treat themselves and their affiliates. Hence, no incumbent utility or any of its affiliates should have any advantage over non-utility and independent suppliers in securing the transmission capacity required to serve its own Standard Offer Service customers. The Federal Energy Regulatory Commission's ("FERC") Order No. 888 is designed to remove any transmission-related impediments to a competitive wholesale market by ensuring equal and non-discriminatory access to the nation's transmission system for all generators. FERC's Order No. 2000 provides for the continued development of regional transmission systems to promote reliability and to further safeguard the ability of all generators to fairly compete for wholesale customers. FERC's recently announced goals of

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establishing consistent interconnection agreements and procedures and standardizing market design are also aimed at further reducing barriers to competition in the wholesale market.

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

Answer: The Commission's Rules are designed to protect consumers while promoting competition in Arizona. Therefore, the most important thing this Commission can do is give the Rules every opportunity to work as intended. For example, the Commission can protect Arizona's customers through Rule 1606.B, which promotes full and robust competition in the wholesale market for power. This will result in: (1) increased system reliability through market-driven upgrades aimed at increasing capacity; (2) the assurance of adequate, market-tested and, therefore, a least-cost power supply that is responsive to customer demand; and (3) retail rates that are not excessive or discriminatory. Wholesale competition is not fraught with risks for Arizona's customers. To the contrary, a vibrant wholesale market is the best protection against price supply risk. But, in order to ensure that the benefits of competition in the wholesale market accrue to Arizona's residential customers, the Commission must ensure that no administrative action interferes with the proper functioning of the wholesale market.

Recent events in California are seen by many as a cautionary tale that teaches about the risks of deregulation in the wholesale and retail markets. California is a cautionary tale, but its lesson is first and foremost that there must always be a sufficient supply to meet current and forecasted demands and also that any wholesale market must be accompanied by appropriate market rules and mechanisms. More specifically, one lesson from California is that state commissions should not erect artificial barriers to competitive, prudently-constructed portfolios of short, intermediate and long-term contracting for power by load-serving entities. Such various length contracts permit customers to receive the benefits of competition in the form of lower and more stable prices and increased system reliability, while permitting load-serving entities to manage risk.

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- 3.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?

Answer: From the generation suppliers' perspective, an important aspect of the competitive framework is the requirement that incumbent utilities must purchase power for standard offer service from either bilateral arms-length negotiated contracts or from the competitive market, with at least 50% being procured through a competitive bid process. Although generation suppliers believe that a competitive wholesale market will have a positive impact on retail rates, it is not the standard offer rates that dictate whether wholesale competition is viable.

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- 3.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?

Answer: Although the general framework of the Rules encourages competition, stranded cost recovery under the Rules can become an impediment to a fully-competitive market, to the extent such recovery reduces a party's incentive to seek competitive supply.

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

Answer: The problem would be mitigated if: (a) the assets are taken out of rate base, (b) the UDC is required to procure all its needs at arm's-length in the competitive market or through bilateral, negotiated agreements and (c) the transmission system is made available on an equal basis to the utility generators.

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- 3.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?

Answer: As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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- 3.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?

Answer: As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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3.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?

Answer: The Commission should continue to require existing utilities to procure power and ancillary services from the competitive market. Rule 1606 mandates utilities to either competitively procure or negotiate arms-length bilateral agreements to purchase power to satisfy their Standard Offer Service obligations. Enforcement of this mandate will promote competition in the wholesale market.

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.

Answer: Yes, Arizona's utilities are taking steps that will delay competition in the wholesale market, and are likely to make wholesale competition even more difficult in the future. Specifically, as discussed, APS and Tucson Electric Power Company have requested that they be freed of their obligation to competitively procure power to satisfy their Standard Offer Service obligations, as required by Rule 1606. The Commission should deny these requests. The Commission should require Arizona's utilities to negotiate in good faith with any third-party supplier willing to enter into a long-term power purchase agreement. PGR and possibly other competitive suppliers, are prepared to enter into such long-term agreements at terms as good as or better than those contained in APS' proposed, sweetheart, above-market PPA with its generation affiliate. Requiring Arizona's utilities to consider such competitive agreements will ensure that competition in the wholesale market will begin sooner rather than later, obviating any concerns the Commission may have regarding the ultimate development of a competitive wholesale market in Arizona.

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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?

Answer: As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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

Answer: As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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4. Retail Generation Competition

A. Regarding each identifiable generation product --

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

Answer: The wholesale market structure in Arizona, if allowed to develop in accordance with the Rules established by the Commission and FERC, would be competitive both in theory and in fact. Many generators would offer power at wholesale to multiple buyers, with prices, terms and conditions established by the market. Generators are currently constructing additional generation to participate in competitive wholesale markets in Arizona. But no matter how good the market structure is in theory, if the Rules are allowed to be used to deprive the market of most of its potential liquidity, as for example would be the case if APS locked up a material portion of its long-term wholesale needs through an above-market contract with its affiliate, Arizona ratepayers would be deprived of the benefits from an effective wholesale market.

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

Answer: As discussed in response to question 2.B.1., this Commission has recognized that in addition to the existing incumbent utilities within Arizona, there are over one dozen potential new entrants to Arizona's wholesale market at various stages of developing new supply within the State. In addition to these resources within the State, Arizona is one of the most active trading locations in the southwestern United States. Most notably, two of the most active trading hubs, Palo Verde and Mead, are directly linked to Arizona's market and traders throughout the WSCC region actively buy and sell wholesale products in all time frames at these locations.

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

Answer: As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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

Answer: Yes. While PGR cannot speak for other generation owners, PGR's generation facility will be able to offer competitive prices relative to existing generation resources, as long as there is an open, transparent marketplace. In fact, the true answer to this question can only be determined in that context. An open, transparent market requires all resources, both existing resources and new entrants, to compete on a "level playing field."

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

Answer: To date, the AISA has had no significant effect on competition in Arizona. The Commission correctly recognized in the Rules that an independent regional transmission organization is "necessary in order to provide nondiscriminatory access and to facilitate a robust and efficient electricity market." A.A.C. R14-2-1609(C). Without some independent body, there would be no rules or protocols in place to address the transmission access needs associated with implementing competitive wholesale and retail markets. A competitive market creates numerous transmission access challenges including the need to adapt transmission scheduling requirements to competitive service, the tailoring of ancillary services to support retail transactions, and the determination of equitable energy balancing requirements. The AISA Protocols provide an invaluable mechanism for addressing these types of issues and resolving any disputes that may arise between the parties.

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4.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?

Answer: As noted in the response to Question 2 above, PGR recognizes that there are currently load pockets in Arizona where transmission constraints affect the ability of any generation supplier to reach load. These transmission constraints, however, do not uniquely impact competitors. Today, Arizona's vertically integrated utilities use the transmission system to deliver power to load. To the extent that the utility is no longer supplying power to serve Standard Offer customers, the utility will no longer need the transmission previously used to serve the load, and the transmission capacity will be available to competitive suppliers supplying power for Standard Offer load. So long as the transmission provider offers non-discriminatory, open access to the transmission system, all generation suppliers, whether competitive suppliers or utility affiliates, will compete on a level playing field.

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

Answer: As long as the transmission provider offers non-discriminatory, open access to its transmission system, any constraints should affect all generation suppliers equally.

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

Answer: As a potential user of the transmission system, PGR defers to responses provided by the transmission providers regarding such plans. However, so long as the transmission provider offers non-discriminatory, open access to its transmission system, any constraints should affect all generation suppliers equally.

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

Answer: FERC, recognizing that transmission owners could use their control of the transmission system to benefit affiliated generation, promulgated Order Nos. 888 and 889 to require open access to transmission systems, separation of transmission and generation functions, and control over use and dissemination of transmission information. If Arizona's transmission owners comply with FERC's open access requirements and Code of Conduct, opportunities to exercise market power should be minimized. In addition, should Arizona's transmission owners transfer control of their transmission facilities to a FERC-approved RTO, exercise of market power will be further limited.

As discussed in the response to question 4.B.1. above, when utility generators cease supplying power for Standard Offer Service, the transmission capacity previously used to serve such customers will be available to the generators supplying power for Standard Offer customers. The "right" to the transmission capacity follows the load - the utility's affiliate has no greater inherent "right" to transmission service.

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.

Answer: All transmission owners are required to provide open access to their transmission systems, and aggrieved parties have the right to complain to FERC if the transmission provider is not providing open access. However, FERC clearly believes that opportunities for discrimination still exist, and is currently promoting formation of RTOs nationwide and standardization of market rules to protect open markets. To date, Arizona's nascent competitive wholesale and retail markets are more threatened, however, by attempts to promote self-serving, sweetheart, non arm's-length negotiated transactions with affiliates that act to lock-out competitive suppliers than by abuse by transmission providers. (PGR will be vigilant regarding the latter concern in the future.) As long as transmission providers allow open access to their transmission system, all generators should be affected equally by transmission constraints.

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As discussed in the response to question 4.B.1. above, when utilities cease supplying power for Standard Offer Service, the transmission capacity previously used to serve such customers will be available to all generators supplying power for Standard Offer customers on an equivalent basis. The utility and its affiliates will have no right to the transmission capacity when they are no longer supplying power for the load.

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?

Answer: Ensuring the transmission system is planned properly to meet the needs of all transmission customers, such as PGR, is a critical element to the long-term success of Arizona's market. While the current transmission owners are responsible for the existing transmission system, PGR believes that the future transmission planning process must be revised to meet the needs of a competitive market. The best means of achieving this objective, however, is to establish a transparent wholesale market and to ensure there is non-discriminatory access to the transmission system. Given the opportunity, market participants will respond to the market signals and will support investments in the transmission system to ensure they can deliver their product. Similarly, the transmission planning process itself must be addressed in an open, non-discriminatory manner. PGR strongly believes that the transmission planning process must be carried out by an independent entity, such as an RTO, to ensure that all users' needs are addressed fairly.

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

Answer: Nearly all major interstate gas pipelines in the WSCC have strategic long-term plans to increase deliverability to match expected increases in power and non-power sector gas sales.

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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?

Answer: As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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wholesale competition, ultimately preventing retail competition from developing.

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?

Answer: No. As discussed above, the Commission should not change the competitive bidding requirements, by individual variance or generic review. Allowing utilities to procure generation through sweetheart contracts with affiliates would reduce wholesale competition, increase prices and prevent retail competition from properly developing.

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?

Answer: No. Changing the competitive bidding requirements (to allow utilities to procure generation solely or even primarily from affiliates) will reduce competition in the wholesale market. If the Commission reduces competition in the wholesale market, retail competition will not develop. Revising the Rules at that point would be futile – without wholesale competition, there can be no “real” retail price competition.

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4.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?
 - b. How would retail generation competition be affected?
 - c. How would wholesale generation competition be affected?

Answer:

If the Commission were to approve a substantial variance to the Rules and permit Arizona utilities to purchase power for Standard Offer customers through self-dealing, sweetheart, above-market, noncompetitively-bid contracts with their generation affiliates rather than through arm's-length, negotiated contracts with non-affiliated or affiliated generators, all markets and ratepayers in Arizona would be adversely affected. Retail competition depends on a robust wholesale market; without a competitive wholesale market, there will be no competitive retail market. Allowing incumbent utilities to effectively bar competition for a significant portion of Arizona's Standard Offer retail load by exclusively dealing with affiliates will drive wholesale competitors from the market, limit future investment in generation, and, thereby reduce electrical supply and increase prices above their competitively-determined level. The Commission should enforce the Rules as written, requiring utilities to immediately begin arm's-length negotiations for bilateral power supply contracts, while concurrently issuing requests for proposals for the competitive bidding portion of the Standard Offer load. This will protect the wholesale market, and allow retail competition to begin as soon as possible.

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

Answer:

Given PGR's earlier response to question 2.B.1., it is apparent that there are more than a sufficient number of competitors to meet the Standard Offer customers' load requirements going-forward after January 1, 2003, as contemplated in the Rules and Settlement Agreement. In addition, the

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current level of development combined with the existing robust trading hubs in the Arizona region suggest that there will be an adequate number of suppliers competing to serve Arizona's market. In fact, there is more than an adequate amount of generation capacity to serve 100% of APS' Standard Offer requirements by the company contracting with non-affiliated, generating entities for its full Standard Offer requirements.

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?

Answer: Retail competition will not develop without robust wholesale competition. The wholesale market in Arizona is still immature. Although several generators are constructing new facilities to participate in the market, if the incumbent utilities are allowed to procure generation for Standard Offer service through self-dealing contracts with their affiliates, some competitors will be driven out of the market, drastically limiting any potential for wholesale competition to discipline prices. Arizona might well end up with a wholesale market, but unless the Commission allows retail ratepayers to have the benefit of multiple wholesale suppliers, there will not be any material impact on retail rates. If retail providers have fewer opportunities for procuring competitively-priced supplies, retail competition will be impeded. Only if the Commission protects the wholesale market will retail competition develop. Bilateral negotiations between affiliates that are not market-tested are not arm's-length transactions; any participation by utility affiliates in the market for Standard Offer generation must be through the competitive bidding process, as envisioned in the Rules.

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?

Answer: The Commission should reject any proposal to modify the competitive bid rules that would allow utilities to procure generation for Standard Offer service outside the competitive wholesale market. Under the Rules, a Utility Distribution Corporation ("UDC") must procure such generation from arm's-length bilateral negotiations or a competitive bid process. UDC affiliates can participate in this process but only if the negotiations are arm's-length or, in the case of the bid process, where there is no preferential treatment. Any deviation from the existing Rules would harm

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wholesale competition, ultimately preventing retail competition from developing.

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?

Answer: No. As discussed above, the Commission should not change the competitive bidding requirements, by individual variance or generic review. Allowing utilities to procure generation through sweetheart contracts with affiliates would reduce wholesale competition, increase prices and prevent retail competition from properly developing.

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?

Answer: No. Changing the competitive bidding requirements (to allow utilities to procure generation solely or even primarily from affiliates) will reduce competition in the wholesale market. If the Commission reduces competition in the wholesale market, retail competition will not develop. Revising the Rules at that point would be futile – without wholesale competition, there can be no “real” retail price competition.

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4.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?

Answer: There are no advantages from approving contracts for Standard Offer Service that would be based on cost-based rates. In fact, there would be many disadvantages to such an approach. The best approach for establishing Standard Offer rates is one based on the outcome of a competitive bidding process, overseen by an independent entity, and administered by the UDC.

Specifically, cost-based Standard Offer Service contract would result in the following disadvantages:

- Arizona's customers would be denied the benefits of access to competitively-determined wholesale prices,
- There would be a chilling effect on the incentives for new entrants to supply power for Standard Offer Service or to invest for Arizona's future requirements. Investors would seek opportunities in other regions where they could benefit from providing competitive resources.
- Suppliers will have little or no incentive to minimize the costs to provide power for Standard Offer Service, which will result in higher overall average costs paid by Arizona's ratepayers over time,
- Companies will have no incentive to offer innovative products and pricing, to the detriment of the ultimate ratepayers of the state of Arizona,
- The market pricing signals seen by suppliers and customers will be distorted since each supplier is paid on the basis of its own costs and based on a complicated set of regulatory accounting principles. The end result is that the lack of transparent market prices will undermine the long-term efficiency of the market,

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- Without proper market signals, there will be little incentive to develop meaningful demand-side response programs², which it reduces the incentives to invest in renewable resources.
- Depending on the duration of the contract, it potentially increases the amount of stranded investments that would have to be paid by ratepayers.
- The regulatory approval process to identify, review and approve such cost-based contracts increases the overall transaction costs to suppliers and ultimately to ratepayers.

Conversely, the advantages of allowing the standard offer service contracts to be based on market-based rates are as follows:

- Arizona's customers would have access to competitive market prices and be assured that the Standard Offer Service price is the best available option, as a result of a competitively-bid, market process.
- Allowing market-based rates to supply the Standard Offer Service will increase the number of potential suppliers willing to provide power for the service. Thus, Arizona will have more suppliers competing to provide service.
- Suppliers will have strong incentives to offer prices lower than their competitors. More importantly, suppliers, not Arizona's customers, will be at-risk to cover increases in their costs to meet their Standard Offer Service commitments.
- The process will produce valuable market price information for future investments and innovations.
- Demand resources will have strong incentives to participate and compete with supply resources. They can participate and reflect their anticipated value in their market-based bid, which would not be possible in a cost-based approach.

A prudent mix of short-term (spot market purchases and bilateral agreements of less than one-year), intermediate-term agreements (one-to-three years) and long-term PPA's (longer than three years) is the most appropriate, conservative diversification strategy for the ratepayers of Arizona, and the stockholders of the

² While California's experience has had very few positive attributes, providing market price signals to customers resulted in a positive demand response and achieved the desired result – customers conserved and reduced the supply by as much as 9% in some instances.

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state's investor-owned utilities. As PGR discusses elsewhere in its response, there are many lessons to learn from the California debacle, but clearly one important, indisputable conclusion reached from that unfortunate episode is that a prudent mix of generation agreement lengths is optimal for all stakeholders. For the public interest of the Standard Offer customers of Arizona and the stockholders of the state's utilities, a prudently-diversified mix of short, intermediate, and long-term timeframes for power purchases is preferable.

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.

Answer: In September 2001, FERC adopted a new market assessment test, the so-called "Supply Margin Assessment" ("SMA"), to replace FERC's existing "hub-and-spoke" analysis. The SMA will be used on an interim basis pending a generic review of new analytical methods for analyzing market power. The SMA computes a region's generation in excess of load (the "Supply Margin"), accounting for import and export capabilities. If a seller's capacity exceeds the region's Supply Margin, the seller fails the SMA screen. The new standard appears to be significantly more difficult to satisfy than the old hub-and-spoke analysis.

The impact of the SMA screen on generators selling into Arizona will likely be minimized, for several reasons. First, only new applicants for market-based rate authority and sellers subject to FERC's triennial market review will be subject to the SMA screen. Most generators capable of selling into Arizona in the foreseeable future already have market-based rate authority, and will only be subject to the SMA screen upon their triennial review. Second, most generators selling power in Arizona will satisfy the SMA screen in any event – sellers most at risk are those selling into a region where they serve native load (and consequently owning large amounts of generation in a single market). Thus, APS, Pinnacle West and their affiliates will face significantly more difficulty satisfying the SMA screen in Arizona than will merchant generators during their upcoming triennial reviews. Finally, when a FERC-approved RTO is operational in Arizona, generators selling into Arizona will no longer be subject to the SMA screen for Arizona projects, as under that environment, it is assumed that an independent market monitor will be instituted to review market power abuse, behavioral and pricing questions.

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In the same order in which it announced the SMA screen, FERC required utilities failing the screen to implement market power mitigation measures, including: (1) offering uncommitted capacity for next-day sales under split-savings rates; (2) purchasing spot energy under split savings rates when the cost is less than the applicant's decremental cost; (3) offering interconnection as a network resource to unaffiliated generators; and (4) employing an independent party to operate and administer its OASIS. These market power mitigation measures should increase transparency and liquidity in spot and forward energy markets, while reducing opportunities to exercise transmission/generation market power. The precise effects of the mitigation measures are unclear, as FERC has delayed implementation of portions of the order pending requests for rehearing.

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?

Answer: Yes. The Commission has the ability to assure that its approval of a long-term contract would protect utilities' ratepayers receiving Standard Offer Service while fostering competition. A UDC will still be required to demonstrate that its purchases of power for Standard Offer Service are reasonable and prudent before it will recover the cost of such purchases in rates. This would include not only a review and oversight of the competitive, arm's-length bid process contemplated by Rule 1606; it would also include a review of reliability measures, security issues, and other purchased power agreement terms and conditions.

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5. 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.

Answer: PGR has not undertaken such a study for this proceeding.

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

Answer: The California experience resulted from a combination of factors, including extreme weather conditions, reduced hydroelectric generation due to hydrological conditions but, most importantly, as a consequence of California not having sited a substantial new power plant in roughly ten years³, and the agreement made between the California Legislature, CPUC and the utilities that essentially required divestiture with no transition contracts and prohibited the utilities from entering into any long-term contracts to manage their risk. These parties agreed to a system where the utilities were required to buy and sell all of their requirements in the daily wholesale spot market, where prices would fluctuate daily, but retail rates were fixed. Thus, the California utilities were exposed to the price volatility inherent in spot markets and were deprived of the ability to hedge volatile spot prices through long-term forward contracts. Western regions outside California were able to avoid some of the volatility of the California market through proper use of forward energy contracts.

The Arizona restructuring framework was built on a foundation of long-term, competitive power supply contracts, negotiated at arm's-length or procured through competitive bid. Both the states of California and Arizona required their utilities to divest their generation assets, but unlike California, the Rules do not require utility electric providers to procure power requirements through volatile spot energy markets alone. Consequently, Arizona will not suffer the price swings and consumer harm caused by exclusive reliance on spot markets. And unless the regulatory framework changes, Arizona should continue to see precisely the kind of new entry that California so sorely lacked. Hence, again, the primary focus of the Commission should be protecting competitive wholesale markets, which will allow retail electric providers to select an appropriate portfolio of generation products, terms and conditions.

³ California's capacity reserve margin shrank from 13.2% in 1993 to less than 4% in 1997, due to the combined effects of load growth and lack of investment in new generating capacity. (Source: WSCC)

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ARIZONA CORPORATION COMMISSION
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FILED: FEBRUARY 25, 2002**

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

Answer: As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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

Answer: FERC's RTO initiative is the latest step in a multi-step federal process that encourages open access transmission service to all generation resources. For generators to effectively compete in a vibrant wholesale market, access to transmission must be provided in a fair and nondiscriminatory manner. By removing barriers to transmission, generators can compete head-to-head enabling an effective wholesale and retail market to evolve in Arizona.

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FILED: FEBRUARY 25, 2002**

- 5.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.

Answer: As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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6. 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.

Answer: As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. These system security questions are being addressed by various federal and state agencies.

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7. 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.

Answer: The Commission's Rules and the 1999 Settlement Agreements offer a well-constructed framework for wholesale and retail competition. The Rules expect Arizona to develop its existing competitive wholesale market, and assume that Arizona utilities will procure generation for Standard Offer Service from the wholesale market beginning next year. The Arizona market is supported by regulations and orders promulgated by the FERC, which has long sought to ensure competition in the wholesale market through open access to transmission and ancillary services, first through open access transmission tariffs, and later through FERC's ongoing effort to encourage the voluntary formation of RTOs nationwide.

There is simply no reason for the Commission to backtrack in any way from the Rules, whether from fear of repeating the California experience or as the result of self-serving pleas from utilities seeking to eschew the competitive market and to enter into sweetheart deals with their affiliates. Competitive generators stand ready to bid for the right to serve Standard Offer customers, or to negotiate bilateral contracts with Arizona utilities to supply reliable power at competitive rates. By acting promptly and forcefully, the Commission can maintain the current schedule, providing for a competitive supply of Standard Offer generation in 2003.

If, however, the Commission bows to pressure and removes the significant capacity represented by Standard Offer Service from the competitive market, the Commission will irreparably damage the competitive wholesale market, likely drive some participants from the market, and certainly drive up future prices by reducing supply. Given that the Commission, the FERC and most market participants recognize that, without a competitive wholesale market, there is little hope for effective retail competition, this outcome could not possibly bode well for Arizona ratepayers, and thus is not in their public interest.

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**PANDA GILA RIVER, LP'S
RESPONSES TO
COMMISSIONER SPITZER'S QUESTIONS
DATED JANUARY 22, 2002**

**PANDA GILA RIVER, LP
DOCKET NOS. RE-00000C-00-0275;
E-00000A-01-0630; E-01345-A-01-0822;
E-00000A-02-0051;
ARIZONA CORPORATION COMMISSION
COMMISSIONER SPITZER'S QUESTIONS
FILED: FEBRUARY 25, 2002**

1. In a vertically integrated utility model, what incentives (regulatory, financial and ratemaking) exist for the expanded use of renewable energies?
 - A. As a participant in the competitive Arizona wholesale electric market, Panda Gila River LP ("PGR") has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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E-00000A-02-0051
ARIZONA CORPORATION COMMISSION
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FILED: FEBRUARY 25, 2002**

2. In a competitive electric market model, what incentives exist for the expanded use of renewable energies?
- A. A competitive electric market model may promote the use of renewable energies more than a vertically integrated utility model. Two of the cornerstones of competition are consumer choice and innovation. Electric providers have the opportunity to differentiate what is otherwise a commodity product by marketing "green" energy, i.e. power generated from renewable resources, to retail consumers. In states that have allowed retail electric competition, consumers have been willing to pay a premium for "green" power, creating a market for such energy products. TEC, an affiliate of PGR, has the pioneer green power program in Florida. In a regulatory model, there is little opportunity for buyers or sellers to promote renewable energy sources. Therefore, the competitive electric market model is essential to allowing customer demand for renewable energy to be met.

In Arizona, studies have shown that a significant number of customers are willing to pay a premium for the ability to choose electricity from renewable energy resources. To date those customers' needs have not been fully met under the vertically-integrated paradigm. There are a number of companies throughout the country who are eager to supply retail and wholesale customers with renewable energy resources. In fact, given the experience of other states, the competitive electric market model has allowed renewable energy offerings and products to flourish to the benefit of those states' customers.

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FILED: FEBRUARY 25, 2002**

- 3.** In a vertically integrated utility model, what disincentives (regulatory, financial and ratemaking) exist for the expanded use of renewable energies?
- A.** As a participant in the competitive Arizona wholesale electric market, PGR focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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4. In a competitive electric market utility model, what disincentives exist for the expanded use of renewable energies?
 - A. In a competitive electric market utility model no inherent disincentives exist for the expanded use of renewable energies. Product differentiation is a cornerstone of effective product marketing. Product choice will expand in competitive market places, where it may be more limited under a vertically integrated utility model.

The competitive market model in Arizona fosters the growth of renewable energies while allowing voluntary "green power" programs to continue. Under the Environmental Portfolio Standard (the "EPS Rule") adopted by the Commission, UDCs and Electric Service Providers ("ESPs") will be required to utilize an increasing supply of renewable energy. In addition, as the size of the market expands, greater amounts of renewable energy will have to be utilized by UDCs and ESPs. This will help foster innovation and advances in technology which in turn should result in lower rates for renewable energies thereby allowing the market to grow in a sustainable manner. Therefore, under a competitive electric market model, there are no inherent disincentives to expand the renewable energy market in Arizona.

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FILED: FEBRUARY 25, 2002**

5. During Arizona's period of reliance on the vertically integrated utility model, what renewable energy programs were enacted in Arizona?
 - A. As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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6. Since Arizona's adoption of a competitive electric market model, what renewable energy programs have been enacted in Arizona?
- A. In conjunction with the implementation of a competitive electric market, the Commission adopted the EPS Rule. (See A.A.C. R14-2-1618.) In general, the EPS Rule requires any UDC or ESP selling electricity or aggregating customers for the purposes of selling electricity to derive a certain percentage of the total retail energy sold from new solar resources or environmentally-friendly renewable electric resources. The requirement became effective January 1, 2001, with a minimum percentage of 0.2% and escalates from 2007 through 2012, with an ultimate requirement of 1.1% of the total retail sales from qualifying sources.

The EPS Rule will foster the development of a long-term sustainable renewable energy market in Arizona. Although the EPS Rule is not dependent upon retail competition, the development of renewable energy sources is part of the competitive wholesale market. Further, a renewable energy market did not develop under the prior vertically-integrated utility paradigm. Under that model there was no requirement to develop or utilize renewable energy sources, nor was there any incentive to respond to consumer demand for such options.

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FILED: FEBRUARY 25, 2002**

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?
 - A. As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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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?
 - A. Under the competitive electric market model new cleaner plants will replace older dirtier plants. Older plants are not only more damaging to the environment, they are also less efficient. The older less efficient plants are more costly to operate and, therefore, produce higher cost electricity. Conversely, new environmentally-friendly plants are more efficient and can produce electricity in a more cost-effective manner. Therefore, the demand for lower-cost power from new cleaner plants will result in older dirtier plants being taken off-line. The replacement of older dirtier plants is greatly enhanced by an effective competitive wholesale market. Without competitive pricing of generation, there is little incentive to build new plants to replace older, dirtier, less efficient, more expensive plants.

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FILED: FEBRUARY 25, 2002**

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?
 - A. As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

**PANDA GILA RIVER, LP
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FILED: FEBRUARY 25, 2002**

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?
 - A. The variances recently requested by APS and TEP have cast a significant amount of regulatory uncertainty over the current Rules adopted by the Commission. The very possibility that variances could be granted, along with the pre-existing market power of APS and TEP, causes significant uncertainty in the competitive electric generation market. This uncertainty could delay or result in the cancellation of new electric generation facilities planned for Arizona. In turn, this would expose consumers to increased rates and power shortages due to insufficient reserve margins and fluctuations caused by demand outweighing supply. In addition, more efficient, more environmentally friendly capacity being added will force the citizens and Standard Offer customers of Arizona to endure the continued operation of the state's older, dirtier, less efficient facilities for the foreseeable future.

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FILED: FEBRUARY 25, 2002**

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?
 - (a) What is the most stringent pollution control measure placed on a CEC during Arizona's reliance on the vertically integrated utility model?
- A. As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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ARIZONA CORPORATION COMMISSION
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FILED: FEBRUARY 25, 2002**

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?
 - (b) What is the likelihood that that measure would have been placed on a similar CEC in a vertically integrated utility model?
- A. Since the adoption of a competitive electric market in Arizona, the Commission has used the Certificate of Environmental Compatibility ("CEC") process to impose pollution control measure requirements on its approvals of new electric generation plants. Protection of the environment appears to be the primary focus of the Commission in determining whether to grant a CEC to a new electric generation plant. One of the Commission's more recent CEC decisions, granting a CEC to Duke Energy for a 600 MW extension of its Duke Energy Arlington Valley plant currently under development, may, on balance, impose the most stringent pollution control measures on any electric generation facility proposed since the onset of deregulation.

The stringent environmental controls placed on the Duke facility, as well as the Commission's recent denial of CECs to other applicants due to environmental concerns, would have been unlikely under the old vertically-integrated utility model. Under the competitive electric market model, regulators have imposed stringent environmental requirements that merchant generators must implement in a cost-effective manner that allows the generator to be competitive. Therefore, under the competitive electric market model rates can remain low, while still obtaining the goal of a cleaner environment.

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- 13.** During Arizona's period of reliance on the vertically integrated utility model, what amount of excess generating capacity existed in Arizona?
- A.** PGR has not conducted a study to be able to respond to this question.

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FILED: FEBRUARY 25, 2002**

14. Since Arizona's adoption of a competitive electric market model, what amount of excess generating capacity existed in Arizona?
 - A. PGR does not believe there is currently any excess capacity in Arizona during peak periods. In fact, during certain times of the year, more costly electric power is being imported into the State.

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PANDA GILA RIVER, LP'S

RESPONSES TO

CHAIRMAN MUNDELL'S
SUPPLEMENTAL QUESTIONS

DATED JANUARY 30, 2002

PANDA GILA RIVER, LP
DOCKET NOS. RE-00000C-00-0275;
E-00000A-01-0630; E-01345-A-01-0822;
E-00000A-02-0051
ARIZONA CORPORATION COMMISSION
CHAIRMAN MUNDELL'S
SUPPLEMENTAL QUESTIONS
FILED: FEBRUARY 25, 2002

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 consumers?
 - b. what would be the risks for Arizona consumers?
 - c. for any identifiable risks, are the risks reduced or increased under a competitive retail regime?

A. At this time, it is highly unlikely that the Public Utility Holding Company Act of 1935 ("PUHCA" or the "Act") will be repealed. Recent events, such as the bankruptcy of Enron, have caused regulators and industry to "step back" and examine the sufficiency of current regulations and industry practices. For your reference, we have attached recent correspondence in this regard from John Dingell, the Ranking Member of House Energy and Commerce Committee, to Harvey Pitt, Chairman of the Securities and Exchange Commission. Although we believe that PUHCA will not be repealed at this time, we will address the issues raised by this question.

Under the integrated utility model, PUHCA was designed to protect consumers. The Act protects consumers by restricting investments by utility holding companies into non-utility businesses; restricting companies from owning other utilities outside of their service territories; and regulating mergers. The repeal of PUHCA, however, would foster the restructuring of electric markets without compromising regulatory protections for Arizona consumers.

The repeal of PUHCA would not result in a regulatory "gap" leaving consumers vulnerable. The issuance of securities will continue to be regulated by the SEC, FERC and the Commission. Additionally, FERC and the Commission will continue to have the authority to prevent any cross-subsidies between a utility and its affiliates and to approve mergers and acquisitions. Consequently, the repeal of PUHCA would not leave Arizona consumers unprotected.

Under a competitive market, the repeal of PUHCA would enable utilities to respond more quickly to consumer demand and changes in the market place. The Act imposes several restrictions on business activities of electric utility holding

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FILED: FEBRUARY 25, 2002**

companies that act as a barrier to competition. PUHCA restricts new market entrants by prohibiting exempt wholesale generators from selling directly to retail consumers. PUHCA also restricts registered holding companies from investing in, or acquiring, non-utility based businesses, thereby depriving consumers of a larger number of companies offering a wider array of services and products. The repeal of PUHCA would remove these restrictions and promote effective restructuring of electric markets, all without jeopardizing Arizona consumers.

January 30, 2002

The Honorable Harvey L. Pitt
Chairman
Securities and Exchange Commission
450 5th Street, N.W.
Washington, D.C. 20549

Dear Chairman Pitt:

For a number of years, we have expressed serious reservations regarding the Commission's support for repeal of the Public Utility Holding Act of 1935 (PUHCA), as well as its permissive administration of the Act. In light of the collapse of the Enron Corporation, we are writing to ask whether the Commission has reconsidered its position on PUHCA repeal. If not, we urge you to initiate a review to determine whether the Commission's support for repealing the Act is appropriate, given what has come to light so far with respect to Enron's activities and what may yet be learned in investigations underway at the Commission and elsewhere.

While inquiries into Enron's activities are in the early stages, the parallels between the circumstances leading to PUHCA's enactment and present day events are striking. As was typical of utility holding companies in the 1920's and 1930's, Enron created a highly complex corporate structure for the apparent purpose of obscuring significant information from investors and engaging in self-dealing transactions with affiliated entities. This brings to mind the Federal Trade Commission's 101-volume 1933 report on holding company practices and this Committee's investigations under Chairman Rayburn's leadership, which paved the way to PUHCA's enactment by documenting abuses such as: 1) the issuance of securities based on unsound asset values, inflated capital structures, and market manipulation; 2) the exploitation of operating subsidiaries through intrasystem profiteering on transfers of assets, cross-subsidization, and financial mismanagement; 3) pyramidal corporate structures resulting in the issuance of excessively speculative securities; 4) the expansion of holding company systems without regard to the integration and coordination of related utility properties; and 5) the concentration of economic power not susceptible to state regulation.

Given what we have learned about Enron's operations, it is fortunate that recent efforts to repeal PUHCA without countervailing protections did not succeed. While Enron purchased one utility, Portland General Electric Company without running afoul of PUHCA, the Act appears to have made further direct investments in investor owned utilities unattractive to Enron.

As the 1995 report of the Commission's Division of Investment Management observed, section 11 of the Act "limits the ability of nonutility companies to diversify into the utility business," and doing so would have required Enron to register under the Act and divest its non-utility ventures. Absent this restriction, Enron might well have drawn more utilities into its byzantine structure, and shareholders who thought they had invested in conservative electric or gas utilities might have seen their funds disappear as the holding company declared bankruptcy. Moreover, expanded Enron ownership of traditional utilities could have compromised not only the price of electricity, but also the reliability of the grid had the company been able to gain control of critical transmission facilities.

In a December 11, 2001, article in the Wall Street Journal, you wrote that "[o]ur current reporting and financial disclosure system has needed improvement and modernization for quite some time" and that inadequate disclosure "creates the potential for a financial 'perfect storm.'" That does little to diminish our concerns about PUHCA repeal, and raises questions about the Commission's dependence on the findings in its Division of Investment Management's 1995 report recommending PUHCA repeal. In a discussion of "whether to retain any federal restrictions on diversification into and out of the utility business," the 1995 report noted:

"Of course, not every investment by a registered holding company in a nonutility business, or by a nonutility company in a utility business, will prove profitable. Indeed, ventures by exempt holding companies into unrelated businesses such as banking, drug stores and real estate have proven largely unsuccessful."

Indeed, over the last decade, a number of exempt holding companies have undertaken ambitious diversification programs, most of which were unsuccessful and some of which proved to be disastrous. Some examples are:

* In the late 1980's, Pinnacle West Capital Corporation, the corporate parent of Arizona Public Service Corporation, lost millions following the failure of Merabank (a savings and loan owned by Pinnacle). This forced Pinnacle to issue debt at the holding company level, serviced by revenues of the operating utility subsidiary.

* In January 1994, Pacific Enterprises agreed to pay \$45 million in settlement of shareholder lawsuits relating to the company's failed diversification into discount drug and sports equipment retailing, and oil and gas operations. The diversification efforts had absorbed \$2 billion and brought the company to the edge of bankruptcy, forcing Pacific to dispose of various nonutility assets, restructure its debt, and change its dividend.

* In 1990, FPL Group, the parent company of Florida Power & Light Co., was forced to take a \$689 million write down for losses associated with an unsuccessful effort to diversify into cable television, insurance, and citrus fruit production.

* In 1992, Hawaiian Electric Industries, Inc., parent of three Hawaiian utilities, was forced to write off \$63.3 million due to losses in two nonutility subsidiaries, one of them an insurance company that had proven unprofitable.

A September 1992 study of utility diversification efforts published in Public Utility Fortnightly concluded that such diversifications have proven "horrendous in the aggregate and...satisfactory to disastrous for individual utilities." This study found that the 20 utilities examined had "invested about \$6.5 billion of common equity in their diversified undertakings and sustained aggregated losses of \$387 million during the six years from 1986 through 1991." The study further noted that "the return on equity on the diversification projects averaged 1.1 percent for the six years."

Notwithstanding these cautionary examples, however, the Commission's 1995 report concluded that PUHCA repeal was appropriate in light of other systemic protections, including financial disclosure requirements:

"Investors are already protected by the disclosure required under the Securities Act and the Exchange Act. The disclosure requirements under these laws are designed to ensure that investors have the information they need regardless of how diverse and complex the operations of a company" (emphasis added).

While we are open to arguments about the need to update PUHCA in the context of a comprehensive bill that addresses the types of abuses that it was enacted to prevent, to the extent the Commission's case for repeal rests on the adequacy of current accounting practices, regulatory vigilance, and what you have characterized as a flawed financial disclosure system, it would appear prudent for the Commission to reconsider its position, in light of the unfolding Enron scandal.

In particular, we are concerned that the Commission's legislative proposal, which depends solely on "books and records" requirements, would pose unjustifiable risks for both investors and electric consumers. As you know, on three occasions Congress has enacted specific exceptions to PUHCA's diversification ban, permitting registered utilities to make limited investments in independent power generation, telecommunications, and foreign utility companies. Each of these legislative exceptions included conditions on the amount of a utility's investment and requirements for state regulatory approval. While the Commission's implementation of these provisions has not been without controversy, particularly with respect to foreign utility companies, to our knowledge they have not undermined the fundamental soundness of any utility or compromised service to electric customers. The fact that the Commission's support for PUHCA repeal is conditioned only on modest "books and records" requirements, rather than more extensive protections such as those included in the three prior legislative exemptions, is troubling. Does the Commission really believe that state utility regulators will have the level of staffing, resources, and technical expertise to fully comprehend potential risks to utility ratepayers posed by corporate transactions as complex as Enron's now-infamous "special purpose vehicle" limited partnerships, as well as its myriad affiliates, subsidiaries, private placements, structured financings, and derivatives businesses?

As recently as December 13, 2001, at a legislative hearing before the Subcommittee on Energy and Air Quality on electric restructuring legislation, Commissioner Hunt testified that while "PUHCA repeal can be viewed as part of the needed response to the current energy problems facing the country," the Commission "does not have a preference as to whether the Act is repealed on a stand-alone basis or as part of broader, energy-related legislation." We disagree with this approach. If PUHCA is to be repealed or otherwise modified, it is incumbent upon Congress to carefully distinguish between provisions which may no longer be warranted and aspects of the Act which still serve a useful and necessary purpose. Additional protections along the lines of the three prior legislative exceptions may be warranted. It also may be necessary to enhance the authority of the Federal Energy Regulatory Commission (FERC) to prevent the abuse of market power under the Federal Power Act, which it is useful to remember was enacted as Part II of PUHCA in 1935.

Since H.R. 3406, an electric industry restructuring proposal which includes PUHCA repeal, may be marked up next month in the Subcommittee on Energy and Air Quality, we would appreciate a response to the attached questions by February 13, 2002:

1. Does the Commission believe that Congress should address PUHCA repeal before pending investigations of Enron, including its own inquiry, have been completed?
2. Does the Commission's reliance on existing financial disclosure requirements to offset risks posed by PUHCA repeal make sense in light of the concerns raised by your December 11, 2001, article in the Wall Street Journal, and the growing evidence of fundamental problems in the conduct of the accounting profession?
3. Has the Commission reconsidered its position on PUHCA repeal since Commissioner Hunt testified before the Subcommittee on Energy and Air Quality on December 13, 2001?
4. If not, will the Commission undertake a review of its position

on PUHCA repeal in order to determine whether modifications are appropriate in light of the direct and indirect causes of the collapse of the Enron Corporation?

As various investigations into the Enron debacle proceed, we may have additional questions for the Commission. Thank you for your assistance.

Should there be questions concerning these matters, please contact us or have your staff contact either Consuela Washington (202-225-3641) or Sue Sheridan (202-226-3400) of the Committee on Energy and Commerce Democratic staff, or Jeff Duncan (202-225-2836) on Representative Markey's staff.

Sincerely,

JOHN D. DINGELL
RANKING MEMBER
COMMITTEE ON ENERGY AND COMMERCE

EDWARD J. MARKEY
MEMBER
COMMITTEE ON ENERGY AND COMMERCE

cc: The Honorable W. J. "Billy" Tauzin, Chairman
Committee on Energy and Commerce

The Honorable Joe Barton, Chairman
Subcommittee on Energy and Air Quality

The Honorable Rick Boucher, Ranking Member
Subcommittee on Energy and Air Quality

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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?
 - A. The Commission's jurisdiction includes the authority to protect retail consumers from potential adverse consequences resulting from multistate companies operating in wholesale markets in Arizona. The competitive market model adopted by the Commission allows consumers to choose Standard Offer rates that continue to be set by the Commission. Therefore, if the competitive market is not functioning effectively, consumers can remain as Standard Offer customers with the full protection of Commission regulated rates. Further, in a competitive market consumers continue to be protected under a variety of state and federal laws regulating the environment, public health, tax and accounting, fraud and deceptive practices, and numerous other laws governing businesses.

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3. How would the existence of effective retail competition in Arizona affect your responses to Questions 1 and 2 above?
 - A. As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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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?
 - A. There is no impact. PGR is not aware of any differences between whether a holding company is registered or exempt under PUHCA regarding its impact on federal or state regulation to protect Arizona wholesale and retail consumers.

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Questions Specifically for Retail Suppliers

5. Explain the retail supplier's corporate structure.
 - A. As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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6. Identify all subsidiary companies and the businesses in which they are engaged.
- A. As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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7. Identify all affiliate companies and the businesses in which they are engaged.
 - A. As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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- 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.
- A.** As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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

- A.** As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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- 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.
 - A.** As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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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.
 - A. As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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- 12.** Provide copies of filings to the SEC and FERC made by the retail supplier and any affiliates or subsidiaries in the last five years pursuant to the agency's administration of PUHCA.
 - A.** As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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- 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 5 years.
- A.** As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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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?

A. The Rules provide for the divestiture or transfer by UDCs of all generation assets to unaffiliated parties or to a separate corporate affiliate or affiliates. This divestiture or transfer is to take place on or before January 1, 2003. After this date, the UDCs are required to purchase power from the competitive market. The provision of retail services by a UDC will continue to be subject to the jurisdiction of the Commission. The entity or entities to which the generating assets are transferred will be subject to the jurisdiction of FERC. FERC has jurisdiction, under Part II of the Federal Power Act, over wholesale sales of power and transmission service, regardless of whether those services are being provided by an integrated utility or by separate entities. Therefore, the separation of facilities that will be used to provide wholesale service from those that provide retail service serves to create a cleaner demarcation between federal and state jurisdiction

However, the Commission's Affiliated Interest Rules (see A.C.C. R14-2-801, et seq.) ("Affiliated Rules") govern transactions between utilities and their affiliates if the local utility is a Class A utility (more than \$5 million in annual revenue). (See also response to Question 18). In addition, the Commission has the authority to review contracts of the UDCs with unaffiliated or affiliated entities that may impact on retail rates in order to ascertain the reasonableness and prudence of the contract.

The Commission will also retain jurisdiction of the siting of power plants and transmission lines pursuant to the provisions of A.R.S. § 40-360, et seq.

Finally, divestiture or transfer of assets, particularly generating assets, will foster the development of competitive wholesale markets, so long as the Commission ensures that the divested entities and independent power producers are able to fairly compete to provide power to utilities for the purpose of satisfying their Standard Offer Service obligations.

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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?
- A. Neither divestiture (to an unaffiliated purchaser) nor transfer (to an affiliate) of generation assets would substantially change FERC or SEC regulation of utility-owned generation assets. Under the Federal Power Act, FERC has jurisdiction over power sold at wholesale, and the facilities used to generate such power. This is true whether the facilities are owned by a vertically integrated utility, a generating affiliate of a utility, or a non-utility generator (like an Exempt Wholesale Generator, "EWG"). Furthermore, transfer of a facility used to generate power sold at wholesale may require FERC approval under Section 203 of the Federal Power Act, at which time FERC would consider the impact of the transfer on regulatory efficiency.

The SEC has jurisdiction over certain public utilities under PUHCA. It is conceivable that the affiliate or unaffiliated purchaser receiving Arizona generation facilities in a divestiture or transfer would qualify as an EWG under PUHCA Section 32. (Arizona utility facilities cannot be EWGs as long as a portion of the generation they produce is sold at retail). If so, the generator would not be subject to PUHCA, whereas the vertically integrated utility, as an "electric utility company" under the Act, would be subject to PUHCA. Nevertheless, the status of the utility holding company (and the UDC entity) will not change, and the SEC will continue to regulate the holding company as a registered holding company or a holding company exempt from registration (as appropriate). In addition, PUHCA forbids an electric utility company from purchasing wholesale power from an affiliated EWG, unless the state regulatory agency has authority to review affiliate transactions to prevent abuse.

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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?
- A. The effects of divestiture or transfer of assets on the Commission's regulatory authority, are discussed in response to Question 14 above. The Commission would retain jurisdiction over retail rates and FERC retains jurisdiction over wholesale rates, regardless of whether such a separation of facilities occurs under a competitive or monopoly framework. Specifically, once a divested entity makes sales of power to a utility in order for the utility to meet its obligations to retail customers, those sales are wholesale sales, subject to FERC's jurisdiction. The Commission does not have less or more authority with respect to wholesale rates if there is one or more than one entity serving retail customers. Additionally, the Commission's authority with respect to retail rates is not affected by the implementation of a competitive retail regime: the Commission remains responsible for ensuring that retail rates are just and reasonable, as required by A.R.S. § 40-203, regardless of the number of retail suppliers in the market.

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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?
 - A. The potential benefits of a separation requirement for the development of a truly competitive wholesale market are enormous, if the Commission requires that utilities honor their commitments to competitively procure, through arm's-length transactions the power necessary to satisfy their Standard Offer Service obligations. (See also Response to Question 14 above.)

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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?
 - 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?
- A. The Commission can continue to ensure that risks associated with the requirement that UDCs divest competitive services to an affiliate are eliminated by upholding the Rules and the Affiliated Rules. The Rules set forth the Commission's support of the AISA protocols and require UDCs to develop a code of conduct, file it with the Commission and then abide by it. (See A.A.C. R14-2-1609 and 16-1616) Both of these elements are critical to ensuring an effective competitive electric generation model.

Additionally, the Affiliated Rules govern transactions by and between utilities and their affiliates. (See A.A.C. R14-2-801 *et seq.*) Approval must also be obtained prior to any transaction in which the utility (1) obtains a financial interest in any affiliate not regulated by the Commission; (2) lends money to an affiliate not regulated by the Commission; or (3) uses utility funds to form a subsidiary or divest itself of any established subsidiary. (A.A.C. R14-2-804.) Additionally, the Affiliated Rules confirm the Commission's jurisdiction to audit and investigate transactions between utilities and their affiliates, as well as require the annual reporting of diversification activities and plans. In sum, the Affiliated Rules allow the Commission to prevent transactions that would impair the financial status of a utility, prevent it from attracting capital at fair and reasonable terms, or impair the ability to provide safe, reasonable and adequate service.

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PANDA GILA RIVER, LP'S

RESPONSES TO

COMMISSIONER IRVIN'S QUESTIONS

DATED FEBRUARY 7, 2002

PANDA GILA RIVER, LP
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COMMISSIONER IRVIN'S QUESTIONS
FILED: FEBRUARY 25, 2002

1. Please address whether Arizona's Constitution prohibits the Commission from giving up *any authority* with respect to the pricing of services by public service corporations, which occur solely within the state.
 - A. The extent to which the Arizona Constitution prohibits the Commission from giving up authority with respect to the pricing of electric services by public service corporations is currently before the Arizona Court of Appeals. Therefore, the exact latitude of the Commission cannot be ascertained at this time. The Commission may not, however, relinquish all authority with respect to setting rates for public service corporations.

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2. Should Arizona be willing to let the federal government take over pricing jurisdiction (market-based rates) for all retail transactions which occur in the state, or is this an inevitable (and proper) result of opening retail markets to competition?
 - A. No. There is no reason that opening Arizona's retail markets to competition should entail giving jurisdiction over retail pricing to FERC. Under the Federal Power Act, FERC has jurisdiction over wholesale sales, and does not have jurisdiction over retail rates. FERC currently allows many sellers to sell wholesale power at market-based rates, but adopting market-based rates for Arizona retail sales will not lead to federal jurisdiction over retail pricing. FERC's denial of the Commission's request for rehearing does not support the contention that once a state adopts a system where generation service is available as a separate product that all transactions fall within FERC's exclusive jurisdiction. Therefore, the Commission cannot relinquish jurisdiction over retail rates to the federal government. A vibrant competitive market requires both a competitive wholesale market (subject to FERC jurisdiction) and a competitive retail market (subject to the Commission jurisdiction).

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3. Can Arizona's UDCs modify their tariffs with the FERC to conform with AISA protocols so that retail transactions can still take place without the AISA? How many times has the AISA been used to resolve disputes over transmission issues to date?
- A. Assuming that the UDCs can demonstrate that their proposed tariff is at least as good as, or better than, FERC's *pro forma* tariff, it should be possible for the UDCs to incorporate AISA protocols into their transmission tariffs. In other states that have allowed retail competition, transmission owners have modified their FERC tariffs to allow retail choice. However, the easier solution would be to incorporate the AISA protocols into a FERC-approved Regional Transmission Organization including Arizona. Some Arizona utilities are participating in the WestConnect RTO, but it is unclear whether WestConnect as currently proposed, satisfies all of FERC Order No. 2000's requirements.

Panda Gila Rive, LP ("PGR") is not aware if the AISA has ever been used to resolve any disputes over transmission to-date.

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4. If the majority of market participants intend to market electricity *only* to industrial, large commercial and load serving ESPs entities, should retail markets be limited by load size to allow those entities with true bargaining power to negotiate Direct Access?
- A. As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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5. What will be a UDC's primary functions in a competitive market?
 - A. As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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6. Is it important to first establish functional wholesale markets before creating robust retail markets in electric generation? If so, why? If not, why?
- A. Yes, functioning wholesale markets are essential to the creation of robust retail markets. A functioning wholesale market provides retailers serving the ultimate end-use customer with the power to choose where they will purchase their wholesale supply requirements. Consider the alternative. If the wholesale market was dysfunctional, retailers would be faced with one of two alternatives: (1) buy all of their wholesale requirements from the incumbent utility or its affiliates or (2) don't participate in the market. Arguably, most potential retailers would likely choose not to participate and there would be no opportunity for true retail competition to exist.

A functioning wholesale market can be characterized as: (1) a market where there are many buyers and sellers; (2) wholesale market prices are determined on the basis of a competitive "bid" process; (3) suppliers are responsible for recovering all of their costs in the market place, meaning that affiliate suppliers have had all of their costs properly unbundled from the regulated utility; (4) all participants have equivalent, non-discriminatory access to the transmission system; and (5) system scheduling, dispatch and settlement procedures are applied in a non-discriminatory way for all participants in the market by an independent entity. The Commission long ago recognized that a robust wholesale market was essential for a competitive retail market, and accordingly that requiring incumbent utilities to purchase power needed to serve Standard Offer customers on the open market was in the public interest. The Commission's vision for competitive wholesale and retail electricity markets will only be possible if the framework established in the Electric Competition Rules and 1999 Settlement Agreements is maintained.

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7. When price caps are lifted for the majority of Arizona consumers, what assurances do we have that volatility in the market (for both natural gas and electricity) will not result in unstable or inflated rates? Will the general price of electricity fluctuate with the price of natural gas?
- A. This question addresses a critical transition issue: whether there will be sufficient measures in place to ensure that prices stay at competitive levels. Clearly, Arizona wants to avoid the situation that occurred in California, as we describe elsewhere in our responses. While it is impossible to give absolute assurances against volatility in either a regulated or a restructured market, PGR offers the following points as reasons that should prevent an unstable transition process in Arizona:
- Unlike California, there is a significant amount of capacity under construction or development (21,000 MW) already in Arizona, which should prevent the scarcity situations experienced in California. This new capacity will increase the supply resources available in the forward markets and help discipline the forward price curves. The existing Rules have motivated development activity in Arizona.
 - Unlike California, Arizona's retail load-serving entities will not be required to buy and sell all of their requirements in the day-ahead market. Therefore, the price of energy will be based on their bilateral contract prices in the forward markets, and not exclusively by the daily spot market prices. These contracts will provide them with a forward hedge against the potential volatility of short-term spot markets.

The price of electricity in Arizona will be dependent upon the marginal fuel resource going-forward. While PGR would expect there to be some link between electric and gas prices under certain circumstance, we would also expect that Arizona's prices would be affected by the volume of electricity being traded at Palo Verde and Meade. At those two liquid trading hubs, the price of electricity is set by hydroelectric, and other resources throughout the WSCC. In addition, PGR would expect that if APS and TEP continue to run their less-efficient, more expensive, older, less environmentally friendly, in-state facilities, then those facilities would often be the marginal resources within the Arizona market.

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8. Should there be a provision added to R14-2-1606(B) which would allow/limit a UDC to contract for wholesale power in three or five year intervals? What would be a proper length for contracts?
- A. A prudent mix of short-term (spot market purchases and bilateral agreements of less than one-year), intermediate-term agreements (one-to-three years) and long-term PPA's (longer than three years) is the most appropriate, conservative diversification strategy for the ratepayers of Arizona, and the stockholders of the state's investor-owned utilities. As PGR discusses elsewhere in its response to Chairman Mundell's questions, there are many lessons to learn from the California debacle, but clearly one important, indisputable conclusion reached from that unfortunate episode is that a prudent mix of generation agreement lengths is optimal for all stakeholders. For the public interest of the Standard Offer customers of the state of Arizona and the stockholders of the state's utilities, a prudently diversified mix of short, intermediate, and long-term timeframes for power purchases is preferable, and will be determined by market forces, not by regulatory rules.

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- 9.** What are the real benefits to residential consumers and small businesses 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?
- A.** As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question. PGR as an EWG is restricted from selling their power directly to retail customers.

**PANDA GILA RIVER, LP
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10. Currently, is residential choice a real option? If not now, when?
 - A. As a participant in the competitive Arizona wholesale electric market, PGR has focused on questions that relate to the wholesale market and wholesale competition. Accordingly, PGR has chosen not to respond to this question.

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11. 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?

A. The most effective way to determine which plants should be retired or replaced is to create an open, competitive market place where all resources compete on a level playing field. Establishing this level playing field requires an even application of all regulatory policies, such as environmental policies, to all participants in the market.

There must also be a clear unbundling of all costs for these existing generating plants, including all costs associated with meeting their existing and future environmental requirements. These plants should be required to compete in an open market and should be responsible for all additional costs associated with meeting all environmental restrictions as would any merchant generating facility. Without this basic principle, these older, dirtier plants will continue to be artificially cross-subsidized by ratepayers, and their owners will have no incentives to remove them from service, to the detriment of the citizens of Arizona.

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12. 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?
- A. The "PG&E situation" was a product of the dysfunctional California market, which saw few generation facilities constructed to meet load growth, forbade the utilities from entering into long-term contracts to hedge market risk, required utilities to buy all power from the spot market, and capped retail rates. The California market allowed the utilities to pass profits to their corporate parents when market conditions approximated design assumptions, but prevented the utilities from acting to prevent accumulation of debt when, for example, natural gas prices rose more than anticipated. By avoiding the design faults built into the California market, Arizona can avoid entirely the "PG&E situation."

Divestiture will not, in and of itself, cause the market impact seen in California, as long as the divesting utility can enter into a prudent mix of differently-lengthed, power supply agreements with competitive generators. Allowing APS to divest generation to an affiliate and enter into exclusive "sweatheart" deals with that affiliate, however, will devastate the wholesale market and harm Arizona's Standard Offer ratepayers.