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Quarles & Brady Streich Lang LLP
Firm State Bar No. 00443100
Renaissance One
Two North Central Avenue
Phoenix, Arizona 85004-2391
TELEPHONE 602.229.5200

Roger K. Ferland (No. 003787)
Laura B. Foster (No. 019776)
Attorneys for Harquahala Generating Company, L.L.C.

Arizona Corporation Commission
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BEFORE THE ARIZONA CORPORATION COMMISSION

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

IN THE MATTER OF THE ARIZONA PUBLIC SERVICE COMPANY'S REQUEST FOR A VARIANCE OF CERTAIN REQUIREMENTS OF A.A.C. R14-2-1606	Docket No.

COMMENTS SUPPORTING REQUEST FOR ORDER TO SHOW CAUSE

By means of this filing, Harquahala Generating Company, L.L.C. ("HGC") hereby expresses its support of and joinder in the Request for Order to Show Cause filed in the above-captioned matter by Panda Gila River, L.P. ("Panda"). A copy of that filing (without attachments) is attached hereto as Appendix "A" and is incorporated herein by reference.

As Panda's filing observes, the above-captioned matter should be immediately stayed until such time as the Arizona Public Service Company ("APS") issues and evaluates responses to a Request For Proposal ("RFP") seeking competitive supply of at least half of APS's projected Standard Offer Service requirements. At this time, it is premature to consider granting APS a variance from compliance with Arizona Administrative Code ("A.A.C."), section R14-2-1606(B) without actually testing the competitive market from which APS would be procuring generation.

Instead of spending the latter part of last year preparing a well thought out RFP, APS has "spent months of analysis and negotiation" drafting a self-serving Purchase Power Agreement ("PPA"), citing the economic benefits to its customers and claiming that there is not enough

generation supply in any event. See Testimony of Jack E. Davis, December 21, 2002, at pp. 3, 4, and 6. If, as APS has argued, the prices behind the proposed PPA are unbeatable and there is inadequate generation supply available, these facts will be proven in the marketplace. Economic theory dictates that competitive bidding is the best way to ensure that customer loads are supplied with the lowest-cost resources. Further, APS cannot reasonably discount the availability of generation without ever testing whether the market could satisfy its load requirement. Rather, only through an open and fair RFP can the APS and the Commission adequately determine if sufficient competitors are willing and able to serve APS's Standard Offer Service load.

To continue with the current proceedings will likely result in what is essentially a mock RFP process. As Panda points out, much of APS's testimony and discovery in this matter seeks to demonstrate that, even if it were to issue an RFP, no supplier other than Pinnacle West Capital Corporation could respond with an offer that is more attractive than the PPA; on the other hand parties opposing the PPA will attempt to show that enough bidders would respond to the solicitation with sufficiently attractive offers. See Panda's Motion at p. 2. For both sides to present evidence predicting what would happen were a competitive bidding process to occur rather than implementing the real thing is a waste of resources, time and money for all interested parties, including the Commission and, more importantly, denies ratepayers the timely benefits of a competitive wholesale market.

And despite APS's contrary assertions, a good RFP can be developed in less than a month, particularly since APS has already determined its power and other requirements as well as how to evaluate any offer to satisfy these requirements. If there is advance notice, bidders should be able to develop good proposals within a month of the RFP's issuance. In addition, the evaluation

process should only take one month. Finally, contract negotiations should take no more than three months. Thus, despite its concerns, APS can accomplish a resource solicitation from start to finish in six months, giving it sufficient time to have competitively bid capacity under contract by January 1, 2003.

Accordingly, for these reasons and the discussion set forth in Panda's filing, HGC supports Panda's request for an order to appear and show cause why the procedural schedule in the above-captioned matter should not be immediately stayed until such time as APS issues and evaluates responses to an RFP seeking competitive supply for at least half of APS's projected Standard Offer Service requirements.

RESPECTFULLY SUBMITTED this 28th day of March, 2002.

QUARLES & BRADY STREICH LANG LLP
Renaissance One
Two North Central Avenue
Phoenix, AZ 85004-2391

By Laura Foster
Laura B. Foster
Roger K. Ferland
(602) 229-5607

Attorneys for Harquahala Generating Company, L.L.C.

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1200 West Washington Street
Phoenix, AZ 85007

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March 28, 2002, to:

Lyn A. Farmer, Esq.
Chief Administrative Law Judge
Hearing Division
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, AZ 85007

Christopher Kempley, Esq.
Chief Counsel, Legal Division
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, AZ 85007

Ernest G. Johnson, Utilities Division
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, Arizona 85007

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and E-01933A-98-0471

By Pam McCauley

3/19/02

BEFORE THE ARIZONA CORPORATION COMMISSION

WILLIAM A. MUNDELL
CHAIRMAN
JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER

IN THE MATTER OF THE ARIZONA PUBLIC SERVICE COMPANY'S REQUEST FOR VARIANCE OF CERTAIN REQUIREMENTS OF A.A.C. R14-2-1606.	DOCKET NO. E-01345A-01-0822 **REQUEST FOR ORDER TO SHOW CAUSE**

Panda Gila River, L.P. ("Panda")[1] hereby moves the Arizona Corporation Commission ("Commission") to order Arizona Public Service Company ("APS") to appear and show cause why the procedural schedule in this Docket should not immediately be stayed until such time as APS issues and evaluates responses to a Request For Proposal ("RFP") seeking competitive supply of at least half of APS's projected Standard Offer Service requirements. By staying determination of APS's Request for a Partial Variance from Rule 1606(B) (A.C.C. R14-2-1606(B)) until the results of the RFP are evaluated, the Commission will most effectively protect Arizona ratepayers, continue the development of competitive wholesale markets, and preserve Commission and Intervenor resources. Requiring APS to comply with Rule 1606(B) by issuing a real RFP will be considerably more effective in demonstrating what the competitive market can and cannot do to meet APS's projected requirements, and would require considerably less effort by APS, Intervenors and the Commission than will be required to proceed with the virtual RFP that APS is attempting to conduct and, indeed, has recognized that it must

[1] Panda Gila River, L.P. is a Limited Partnership, whose General Partners are Panda GS I, Inc. and TPS GP, Inc. TPS GP, Inc. is a wholly owned subsidiary of TECO Power Services Corporation.

conduct, in order to meet its burden of showing that the requested variance is in the public interest.

As discussed more fully below, to sustain its argument that the proposed PPA is prudent and in the public interest, APS must show that, as a practical matter, even if it were to issue an RFP, no supplier other than Pinnacle West Capital Corporation ("PWCC") could respond with an offer for all or a portion of APS's projected Standard Offer Service requirements that is as or more attractive than the contemplated affiliate deal between APS and PWCC. Much of APS's discovery seeks to demonstrate exactly this point. Parties opposing the PPA, on the other hand, will attempt to show that APS's assertion is not true, and that enough bidders would respond to the solicitation with sufficiently attractive offers to justify its issuance. Either way, then, both sides will try to show what would happen were there to be an RFP. It would, therefore, be far more efficient and infinitely more prudent to just have a real RFP, rather than to create a surrogate solicitation during the course of this proceeding (through testimony and discovery), especially because an RFP could be undertaken quickly and without any harm whatsoever to Arizona ratepayers. Indeed, the only way an RFP could take "the better part of a year" to complete, as APS contends (Request for Partial Variance ("Request") at 8), would be if APS actually were to receive one or more *bona fide* offers, which, however, would only prove that APS's request for a partial variance was not justified in the first place.

The plain and simple fact is that APS's request for a variance, together with its request for approval of the associated PPA, cannot be sustained unless both are shown to be in the public interest. Neither can be in the public interest unless APS was prudent to pursue the request and enter into the PPA. Unless APS first is required to issue an RFP or otherwise attempt in good faith to seek to procure supplies at arms-length from non-affiliated suppliers, as it is required to do under Rule 1606(B), it cannot show that its

actions were prudent. Indeed, this must be so, because it is impossible for APS ever to prove that it acted prudently in shunning competing offers from *all* interested suppliers capable of serving all or a portion of APS's Standard Offer Service requirements, in favor of whatever limited number of offers APS succeeds in eliciting from the limited number of Intervenors in this proceeding.

This request is supported by the following Memorandum of Points and Authorities.

MEMORANDUM OF POINTS AND AUTHORITIES

I. IT IS PREMATURE TO CONSIDER GRANTING APS A VARIANCE FROM COMPLIANCE WITH RULE 1606(B).

A. Introduction.

In promulgating the Competition Rules, this Commission determined that wholesale and retail electric competition were in the public interest, and that, to encourage the further development of the competitive wholesale market necessary to allow development of a competitive retail market, utilities like APS should be required to separate their generation assets from their transmission and distribution facilities and to procure the power required to serve Standard Offer customers from the competitive market, with no less than half procured through competitive bids (with the remainder purchased through arms-length bilateral contracts). *See* Decision No. 61272 (December 11, 1998).

On October 6, 1999, the Commission issued Decision No. 61973 approving the May 14, 1999 Settlement Agreement entered into by APS (the "APS Settlement Agreement"). The APS Settlement Agreement, among other things, included retail rate reductions and set the amount, method, and timing of APS's stranded cost recovery. As part of the negotiated compromise, the Settlement Agreement also granted APS a two-year extension (until January 1, 2003) to transfer its generation assets to an affiliate and to

comply with Rule 1606(B)'s competitive procurement requirements. *See* Decision No. 61973 at 4.

B. <u>APS has made no effort to comply with Rule 1606(B)</u>.

Despite agreeing to comply with Rule 1606(B) no later than by the end of 2002, APS has utterly failed to take any significant action to do so. *See* APS Responses to Panda Gila River L.P.'s First Set of Data Requests, copy attached hereto at Tab 1. Indeed, even though APS took many months to complete its agreement with PWCC, months that it could have used to proceed with an RFP, it has done nothing to satisfy its 1606(B) or Settlement obligations. Instead, it now asks this Commission to change the Rule, a change that APS attempts to justify by asserting that the competitive market "will not produce the intended result of reliable retail electric service for Standard Offer customers at reasonable rates." Request at 1. Hence, in the instant proceeding APS seeks to show through discovery and by expert opinion and other testimony that there could not possibly be any attractive alternatives to the APS-PWCC PPA. *See* APS Data Request 1-3, attached hereto at Tab 2. Obviously, however, the prudent way to assess the truth of APS's assertion with any degree of certainty and fairness is to ask the competitive market to respond to, and for the Commission to interpret the results of, a real RFP.

Furthermore, allowing APS to be exempted from Rule 1606(B), without ever issuing an RFP to determine market participant interest and ability to supply up to half of its Standard Offer Service load, will cause substantial uncertainty in the developing wholesale market, threatening the foundation upon which all of the Competition Rules are built. On the other hand, requiring APS to immediately comply with the Rules through issuance of an RFP under the procedures outlined below before commencement of the Commission hearing on the requested variance will not require substantial effort by APS, will obviate the need for ill-conceived regulatory substitutes for the competitive market, and will protect the public interest. Indeed, Panda expects that an APS RFP under

Commission supervision will clearly demonstrate that APS's request for an exemption from the Rules is wholly unjustified and, therefore, completely unnecessary and counterproductive from the standpoint of the public interest.

Finally, APS also appears to believe that it is too late for it to proceed with an RFP and that it would take too long for the results to be known and for contracts to be negotiated. Even if this were true (which, as shown below, it plainly is not) the fact is that APS itself decided, unilaterally and without timely seeking the approval of this Commission, to effectively suspend Rule 1606(B) and not to honor its Settlement obligations. Panda respectfully suggests that this Commission should not let APS's own neglect of a Commission Rule and of a Commission approved Settlement Agreement form the predicate for the relief APS now seeks.

C. The Process Proposed in this Proceeding Will Result in a Poorly Conceived Regulatory Substitute for Competitive Bidding.

As discussed above, Rule 1606(B) requires APS to procure all of the power needed for Standard Offer Service customers from the competitive wholesale market no later than the beginning of 2001. The APS Settlement Agreement extended this deadline to January 1, 2003. But rather than honor its obligations under both the Rules and the Settlement Agreement, APS now asks to be excused from its failure to comply before the fast-approaching deadline. So much is clear from APS's discovery responses in which APS admits that it "had not completed procedures or a schedule to implement the competitive bidding process as set forth in Rule 1606(B) [and that its] effort is somewhat dependent on the substance and timing of the Commission's actions on APS's request for a partial variance . . ." APS Response to Data Request 1.3, Tab 1. When asked whether it had issued any RFPs or other solicitations to purchase power through prudent, arms-length transactions, APS responded that not only had it yet to issue a formal RFP, but that there was no requirement to do so, and that certainly "there is no requirement prior to 2003."

APS's Response to Data Request 1.6, Tab 1. Plainly, APS is using its request for a partial variance, together with the APS-PWCC PPA, as a substitute for its actually determining the ability of the competitive market to meet the Standard Offer needs of APS's ratepayers.

There can be little doubt that were the PPA to be accepted, this would effectively eliminate any meaningful competitive procurement of APS's Standard Offer Service requirement. This result would be particularly damaging to APS's ratepayers insofar as the PPA also contains terms favorable to the affiliate that would never be found in a competitively-procured purchased power contract. But even if the Commission were now to agree with these contentions, the fact is that in order to prove that its variance request and proposed affiliate transaction are prudent and in the public interest, APS must demonstrate that there are no competitors in the wholesale market able to supply power to meet all or a portion of APS's Standard Offer Service requirements during the term of the PPA, and that, were APS to issue an RFP in accordance with the Rules, no competitive supplier would step forward with an attractive offer. Those opposing the requested variance, on the other hand, will have to respond that they are willing to make a more attractive offer than the proposed PPA for all or a portion of APS's requirements, and for all or a portion of the PPA's term, which could be as long as 30 years. Of course, this is just what they would have to do in response to a formal RFP.

In short, then, both sides in this proceeding will present evidence designed to show what would happen if APS were to comply with the Rules. Indeed, it is precisely for this reason that APS issued data requests designed to elicit exactly the same information that it would request and receive through an RFP, albeit from a much narrower group of potential suppliers (as only certain suppliers that are Intervenors in this proceeding received the requests) and without the confidentiality provisions included in true RFPs to

protect bidders from having to divulge their individual business plans. For example, APS asked Panda, to:

> [S]tate whether Panda is willing to offer APS power for any of the years 2002 through 2015 at a lower delivered cost than available to APS from the Dedicated Units under the proposed PPA. If the answer is yes, please state the years for which such an offer is made, the amount of energy and capacity Panda is willing to supply in each of the years 2002-2015, the price of energy and capacity offered for each of the years 2002-2015, and all other relevant terms and conditions under which such offer is made for each of the years 2002-2015.

APS Data Request 1-3, attached hereto at Tab 2. Panda is informed that APS made identical requests to Reliant, Duke, Sempra and other Intervenors.

Even without APS's data requests, however, parties opposing APS's proposed variance and PPA obviously will attempt to present evidence that is, for all practical purposes, identical to the information they would be required to provide pursuant to an RFP. Indeed, *any* information APS believes to be important can be requested in an RFP, and the RFP can be scored on the basis of this information, or any other reasonable criteria APS believes would be appropriate in assessing the bids. Put simply, undertaking a properly administered RFP, as opposed to an RFP established and scored through discovery, testimony and cross examination at a hearing, is the best and only way for APS to establish any predicate for the Commission granting its variance request in the first place.

Unless this Commission orders APS to conduct a commercially reasonable RFP, a quasi-RFP *will* be conducted in this proceeding, not through a competitive process, but through a wasteful litigated process that, at best, will result in an inadequate regulatory substitute for a true RFP and the squandering of Commission resources and ratepayer dollars. And, unlike a case where APS actually sought arms-length bids, even if APS were correct in rejecting all of them, here, APS cannot possibly be deemed to have been prudent in not even seeing if the market could satisfy all or a sizable portion of its needs.

Finally, the makeshift "solution" developed by APS through this proceeding not only will take longer than would a properly conducted RFP process, likely place an unnecessary strain on Commission resources, and cost all parties involved far more in litigation expenses and consultants' fees than would be expended in a proper RFP (in which power suppliers participate as an ordinary cost of doing business), but it also will provide the Commission with a very poor mechanism to meet its statutory obligation of determining whether APS's requested variance is in the best interest of APS's Standard Offer Customers. *See* A.R.S. § 40-361 (requiring charges to be just and reasonable). Indeed, by adopting the procedure outlined below, the Commission will be in a much better position to rule on APS's request and to issue a factually supportable decision.

II. THE COMMISSION SHOULD REQUIRE APS TO COMPLY WITH RULE 1606(B).

A. An RFP Issued Pursuant to Rule 1606(B) Would be Easy to Administer and May be Done Quickly.

APS's suggestion that it is unable to comply with Rule 1606(B) because an RFP would take at least "the better part of a year" (Request at 8) is simply not true. In 1998, for example, Virginia Electric and Power Company ("VEPCO") also attempted to argue that it did not have time to pursue an RFP. The Virginia Corporation Commission rejected VEPCO's contentions and ordered it to issue an RFP on an accelerated timetable. In a hearing, the Virginia Commission solicited and received interest in bidding, and also heard about market power concerns if the utility were to build certain new plants. As a result of the hearing, the Virginia Commission ordered the utility to issue an RFP with the oversight of its Staff. *Application Of Virginia Electric And Power Company For Approval Of Expenditures For New Generation Facilities Pursuant To Va. Code § 56-234.3 And For A Certificate Of Public Convenience And Necessity Pursuant To Va. Code § 56-265.2*, slip op. at 15-16 (Jan. 14, 1999) (attached hereto at Tab 3). Unlike the schedule that APS assumes would be required, the Virginia Commission Order was issued

on January 14, 1999; a draft RFP, with an online date for the capacity of July 2000, was required five days later; three days were set for review of the RFP by Virginia Commission Staff; and bids were due by March 26, 1999. *Id.* at 18. On March 26, 1999, Virginia Commission Staff witnessed the opening of the bids, which had previously been sealed. Thereafter, the Company analyzed the bids received and submitted its analysis to the Staff for its review. The Virginia Commission Staff then filed a report of its own analysis and review of the bids on April 2, 1999, in both public and proprietary versions. Thus, the entire process, from Commission order to Staff report, took only 71 days. And even had there been detailed review and scoring of the bids by an independent consultant (instead of Virginia Commission Staff), the entire process could easily have been completed in 90 days.

Similarly, Arizona Electric Power Cooperative issued an RFP on August 15, 2001, with the stated intention of completing the process by the end of 2001, a period of no more than four-and-a-half months. *See* AEPC RFP, attached hereto at Tab 4. While each of these RFPs was for less power than is projected to be required to serve APS's needs, the process of developing and issuing the RFP and scoring any submitted bids should not impact the timing. If the Commission issues an order similar to that issued by the Virginia Commission, the entire process, from issuance of the RFP to review of bids, could be completed in three months. The fact is that numerous Fortune 100 companies have been acquired in much less time, as have many utility-divested generating plants.

Significantly, though, here the process should be substantially easier because APS already has determined its power and other requirements, as well as how to evaluate any offer to satisfy these requirements. Presumably, these determinations are reflected in the APS-PWCC PPA. Thus, it should require little additional effort for APS to draft an RFP for release to interested suppliers (including Pinnacle West Energy Company ("PWEC")

or PWCC) stating just what it needs and how it expects to evaluate or score any offers to satisfy all or a portion of those needs.

APS clearly believes, as did VEPCO, that sufficient competitors will not come forward to submit bids in response to any RFP. As the Virginia Commission concluded, if "this is the case, then evaluation of any responses to the RFP . . . should not be difficult. However, the Commission finds that the Rules, and sound policy, dictate that the market be provided the opportunity to express itself through the bidding process." Slip op., Tab 3 at 15. Only if the RFP results in one or more *bona fide* offers will the evaluation process be time-consuming.

As was also the case in Virginia, to ensure the process is fair and objective, the RFP must either be supervised by Commission Staff or by an independent, third-party consultant proposed by APS and approved by the Commission.[2] This is particularly the case, here, since APS has already stated its intention to take its entire Standard Offer Service requirements from its affiliate. Given that APS's proposed PPA provides for use of a consultant if the utility seeks competitive bids for additional power and PWCC seeks to compete for such load, use of an independent consultant in the first instance should be no more objectionable.

While the Commission need not dictate a specific process for all details of the RFP, the Commission should consider establishing the following milestones, similar to the procedure followed in Virginia:

- APS submission of proposed RFP to the Commission or consultant and Intervenors – within 5 days of Order in response to this Motion;

[2] The consultant would ensure that the RFP was designed so as not to favor any particular party, including APS and its affiliates. At a minimum, Panda expects that the RFP would require APS/PWCC to bid individual units on a pay-for-performance basis, and that the RFP would allow bids for generation facilities not expected to come on-line until after 2003. Other interested parties would be permitted to present additional issues to the consultant after APS proposes terms of an RFP.

- Interested parties submit comments on proposed RFP to Commission or consultant – within 5 days of submission of proposed RFP (10 days after Order);
- Commission/consultant revisions to RFP – within 5 days of submission of RFP (15 days after Order);
- APS issuance of approved RFP – day after receipt of approved RFP (16 days after Order);
- Bids submitted to Commission/consultant – 45 days after issuance of RFP (61 days after Order);
- Preliminary report of bidders submitting bids, capacity bid, and assessment of bid prices by Commission or consultant – 3 days after submission of bids (64 days after Order); and
- Final scoring of bids submitted – 20 days after preliminary report (84 days after Order).

Moreover, in preparing the RFP, APS should be required to develop and publish (1) proposed bid evaluation criteria; (2) its timetable for compliance with the schedule set forth above; and (3) a mechanism whereby all bidders are notified concerning all questions and associated responses during the bid process.

Finally, in order to ensure that APS is fulfilling the Commission's order in a timely manner, the Commission should appoint a member of its Staff or other designee to monitor and report on APS's RFP process and whether APS is adhering to the proposed timetable. Only by requiring the participation of an independent monitor can the Commission be assured that APS will be able to timely and adequately comply with Rule 1606(B).

B. Use of an RFP as Discussed Herein Will Preserve Commission Resources.

An open and fair RFP is the only means by which the Commission can adequately determine if sufficient competitors are willing and able to serve APS's Standard Offer Service load. It is true that the RFP process will itself require Commission oversight, but overall Commission administration resources will be preserved, in at least two ways. First, APS and other parties will not be forced to submit "bids" through discovery and testimony, and the Commission will not be required to rule on the numerous disputes that will arise in connection therewith or to issue a ruling on the ultimate issue in the variance proceeding, namely, whether sufficient competitors exist to satisfy APS's requirements, without being afforded the opportunity to review the best evidence on this issue, *i.e.*, the results of a real RFP. Any necessary hearing after the RFP could be limited to an assessment of the bids received and the scoring of the bids.

Second, winning bidders from an open and fair RFP (even APS's affiliates) would face a substantially easier Federal Energy Regulatory Commission ("FERC") approval process. Thus, the Commission would be saved from a potential situation in which it approves the APS-PWCC PPA, but the PPA is then modified by the FERC, in which case the Commission either would have to approve it yet again, or the PPA never goes into effect because it is rejected by the FERC. It is simply a waste of administrative resources to conduct a hearing to approximate an RFP instead of conducting a real RFP, particularly in circumstances where the Commission has a good reason to believe that APS will again require the Commission to approve the PPA following its consideration by the FERC.

C. APS Had Plenty of Time To Issue An RFP But Chose Instead To Spend Months Negotiating A Self-Dealing PPA That Calls Into Question Its Grant Of Market-Based Rate Authority.

APS will have only itself to blame if it is required to initiate an RFP on an accelerated schedule. By APS's own admission, "months of analysis and negotiation . . .

went into the final form of the PPA." Testimony of Jack E. Davis at 3. During this time, APS easily could have sought competitive bids, and had it not received any offers that it considered to be as attractive as what it expected to receive or that it already knew it could receive from its affiliate, *then* it could have requested an appropriate variance from Rule 1606(B). It would be most unfair, however, not only to the numerous non-affiliated wholesale suppliers, many of whom are not even Intervenors in this case, but to APS's ratepayers as well, to reward APS's delay by allowing its actions to become a self-fulfilling prophecy.

Furthermore, in light of its FERC filing to retain its market-based rate authority, APS should be estopped from arguing to this Commission that a competitive bidding process would be a waste of time. As recently as March 2000, APS informed the FERC that the wholesale market in Arizona was competitive and APS did not have generation market power.[3] In that filing APS noted that it controlled only 5.2% of the generation in the relevant first tier markets. On April 21, 2000, PWCC filed a request for Market-Based Rates, relying in large part on the APS market power study. In granting PWCC market-based rate authority, as with APS before it, the FERC ordered each to "inform the Commission of any change in status that would reflect a departure from the characteristics the Commission has relied upon in approving market-based pricing." *Pinnacle West Capital Corporation et al.*, 91 FERC ¶ 61,290 (2000). Neither PWCC nor APS has informed the FERC of any such change in circumstances and APS should not be heard to argue to this Commission that there is simply no relevant competitive alternative to supply all or a portion of its Standard Offer Service requirements.

[3] Updated Market Power Study of Arizona Public Service Company, filed March 13, 2000 in Docket No. ER00-1875-000.

III. EVEN IF THE COMMISSION APPROVES APS'S REQUEST, FEDERAL APPROVAL OF THE PPA IS UNLIKELY ABSENT APS CONDUCTING A FORMAL RFP OR OTHERWISE ENTERING INTO ARMS-LENGTH TRANSACTIONS WITH NON-AFFILIATES.

A. Federal Standard for Approval of Affiliate Transactions.

As noted in Section 11.1 of the PPA, the PPA cannot become effective until approved by the FERC. In addition to the APS-PWCC PPA, the FERC also must approve the contract between PWCC and PWEC.[4] APS has not indicated whether it intends to justify the contracts at the FERC on a cost-of-service or market basis. As discussed below, APS will be unable to justify the contracts on a market basis unless it first seeks competitive offers from the market. And if APS attempts to justify the contracts on a cost-of-service basis, it would then, absent an RFP, be unable to demonstrate to the Arizona Commission that the contracts were prudent, as such an argument requires APS to prove that there will be no competitive suppliers able to supply all or a portion of APS's Standard Offer Service requirements during any relevant time period. Indeed, Rule 1606(B) implicitly recognizes that the only prudent purchase is one from the market, if market alternatives exist.

As the FERC has stated on numerous occasions, transactions between traditional public utilities with captive customers, such as APS, and an affiliated power supplier, like PWCC, raise concerns of cross-subsidization and market power gained through the affiliate relationship. In *Boston Edison Company Re: Edgar Electric Energy Company*, 55 FERC ¶ 61,382 (1991) ("*Edgar*"), the FERC held that, in analyzing market rate transactions between an affiliated buyer and seller, it must ensure that the buyer has chosen the lowest cost supplier from among the options presented, taking into account

[4] Under the Federal Power Act, the FERC has jurisdiction over wholesale sales of energy in interstate commerce. 16 U.S.C. § 824 (2000). Wholesale contracts are not effective unless and until the FERC determines that the rates and terms of the agreement are just and reasonable. 16 U.S.C. § 824d.

both price and non-price terms. Stated another way, the FERC must ensure that the buyer has not preferred its affiliate without justification. *Id.* at 62,168.

In *Edgar*, the FERC noted that it may be possible for a utility to demonstrate that it had not unduly favored its affiliate through a market test, which uses a bid or benchmark analysis to determine whether the transaction in question was one that could have resulted through arms-length negotiations between an unaffiliated buyer and seller. Specifically, the FERC presented three means (which it stated were nonexclusive) to demonstrate lack of affiliate abuse: 1) evidence of direct head-to-head competition between the affiliated seller and competing unaffiliated suppliers in either a formal solicitation or in an informal negotiation process; 2) evidence of the prices that nonaffiliated buyers were willing to pay the affiliated seller for similar services; or 3) benchmark evidence of market value, based on both price and non-price terms and conditions, of contemporaneous sales made by nonaffiliated sellers for similar services in the relevant market. *See id.*; *see also Ocean State Power II*, 59 FERC ¶ 61,360, 62,332 (1992), *order denying reh'g and granting clarification*, 69 FERC ¶ 61,146 (1994) ("*Ocean State II*").[5]

1. Head-to-Head Competition.

The FERC did not review an affiliate contract justified on the basis of head-to-head competition until 1999. *See Aquila Energy Marketing Corp.*, 87 FERC ¶ 61,217 (1999) ("*Aquila*"). In *Aquila*, the FERC approved proposed contracts between a utility and its affiliated power marketer based on a brief review of the RFP process used by the utility to solicit bids for capacity and energy. Since *Aquila*, the FERC's review of affiliate contracts has been more cursory where the contracts arose out of an RFP process. *See, e.g.*, *Southern Power Co.*, 97 FERC ¶ 61,279 (2001) (accepting several affiliate PPAs, noting in a footnote that "[t]he PPAs accepted for filing herein were entered into pursuant to an RFP process that [the FERC] has found adequately addresses affiliate abuse

[5] To date, no utility has attempted to justify a contract through prices nonaffiliated sellers have been willing to pay in a bilateral contract, although FERC has indicated that such an approach would be acceptable.

concerns"). It is clear that affiliate contracts that are the result of a fair RFP process will be accepted by the FERC.

2. Benchmark Analysis.

Ocean State II remains the only case in which the FERC approved a contract between a public utility and its affiliate based solely on "benchmark" testimony. There, the FERC explained that several factors must be considered when performing and reviewing a benchmark analysis: 1) the relevant market; 2) the contemporaneousness of the benchmark evidence; and 3) comparability. In addition, the FERC will review the non-price terms of the contract as well.

In *Ocean State II*, the FERC defined the relevant market as the market for long-term bulk power, the same product being sold under the APS-PWCC affiliate contract, and noted that the market consists of all sellers capable of supplying the relevant product to the buyer or set of buyers. The pertinent benchmark evidence consisted of all contracts for comparable delivery to, and negotiated in the relevant market during the period in which the purchasing utility decided to enter into a contract with its affiliate. *See Ocean State II* at 62,333; *Edgar* at 62,169.

The FERC also requires a comparative analysis of non-price terms, including availability guarantees, fuel price risks, development and regulatory risk, inflation, taxes, and purchase and renewal options. Indeed, because benchmark comparisons necessarily involve "projections of formula variables (e.g., fuel cost, plant factors and economic indices) over the life of the project, . . . [t]he assumptions underlying these projections and the significance ascribed to non-price factors are critical to the analysis." *Ocean State II* at 62,335 (quoting *Edgar* at 62,129). Hence, in *Ocean State II,* the applicant made price comparisons by making certain "stated assumptions" with regard to fuel price escalation, inflation rates, O&M expenses, availability factors, and capacity factors so that the price

of each benchmark contract could be restated in mills/kWh based on these common assumptions.

B. Because FERC Approval of the Two PPAs is Unlikely Absent APS Attempting to Procure its Requirements Competitively, Requiring APS to Undertake an RFP Will Not Delay Either the Divestiture Plan Nor Any of the Commission's Competition Goals or Otherwise Adversely Affect Ratepayers.

To obtain FERC approval of the APS-PWCC and PWCC-PWEC contracts, APS and its affiliates must either demonstrate that the contracts were the result of a competitive solicitation providing for direct head-to-head competition with unaffiliated sellers or that the affiliate contract is equivalent, both on price and non-price terms, to other agreements entered into in the same relevant product market at the same time as the affiliate contract.[6]

Clearly, APS cannot rely on the former justification, as the sole purpose of its filing in this proceeding is to evade direct competition. And, try as it may, APS also will not likely succeed in justifying the contracts based on competitive benchmarks. APS's benchmark analysis relies exclusively on contracts entered into between the California Department of Water Resources ("DWR") and merchant generators negotiated nearly a year ago, for delivery only into the California market. *See* Testimony of William H. Hieronymus at 5. Interestingly, these contracts have recently been challenged by the California Public Utility Commission and the California Electricity Oversight Board at the FERC, on the grounds that the contracts, "which were executed at the height of the California electricity crisis and tainted by market power, are unjust and unreasonable." *California Electricity Oversight Board v. Sellers of Energy and Capacity Under Long-Term Contracts with the California Department of Water Resources*, Docket No. EL02-62-000 (filed February 26, 2002).[7]

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[6] Because the divestiture has not yet occurred, APS cannot argue that the services and prices offered by PWCC to APS are similar to what other non-affiliated buyers agreed to accept from PWCC. And, given the PPA's terms, neither will it be able to justify the PPA on a cost-of-service basis.

[7] The use of these California contracts for comparison purposes is especially troubling given that APS made it a point to highlight its "comprehensive education campaign" to "educate and reassure customers that the energy situations in

Regardless of whether the DWR contracts in fact are comparable, the FERC certainly will not accept this argument before it resolves the DWR complaints on the merits. Moreover, even were it to take on the DWR issues today, and APS were to submit its PPA today, the FERC undoubtedly would convene at least a paper hearing, if not a full-blown trial-type hearing, either of which would take months to conclude. Then it would take many more months for the FERC actually to rule on APS's application. Without question, then, the FERC approval process will take at least as long as it would take for APS to issue and score an RFP.

In short, APS faces the Sisyphean task of convincing the FERC that both affiliate contracts (the APS-PWCC PPA and the PWCC-PWEC PPA) are just and reasonable based on a comparison to non-contemporaneous contracts for different products and with vastly different nonprice terms entered into a year earlier under circumstances leading the power purchaser itself (through its agents) to challenge the contracts and to seek their selective abrogation due to alleged overcharges exceeding $13 billion. APS does so, presumably, knowing that if it conducted a fair RFP that resulted in awarding the contract to its affiliate, FERC approval would likely be a simple matter.

IV. CONCLUSION.

Absent an order staying the procedural schedule in this proceeding and directing APS to conduct an RFP as outlined above, the Commission, ratepayers and market participants cannot be assured that APS will timely comply with Rule 1606(B), or, indeed, ever will meaningfully comply with the Rule. If, however, APS issues an RFP, the question as to whether a contract between APS and its affiliates is even necessary will be answered. The end result will be that APS either will have competitively procured wholesale power contracts for Standard Offer Service, as contemplated by Rule 1606(B), or the bidding process will prove that its affiliate PPA is appropriate. Either way, the need

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California and Arizona were much different . . . ." Testimony of Jack E. Davis at 15.

for the Commission to hold a lengthy hearing will be obviated, and an RFP process, therefore, would not take any more time to conclude than would the Commission's proceeding to hear APS's request for a partial variance on the schedule currently contemplated. In addition, and perhaps ultimately most importantly, if the Commission were to require APS to undertake an RFP, it then would be able to take comfort that any wholesale contract, even one between APS and its affiliate, that emanated from that RFP process would not only be more likely to be approved by the FERC, but would in fact be prudent from the standpoint of APS's ratepayers.

RESPECTFULLY SUBMITTED this 19th day of March, 2002.

FENNEMORE CRAIG

By: _____

C. Webb Crockett
Jay L. Shapiro
Fennemore Craig
3003 N. Central Ave., Suite 2600
Phoenix, AZ 85012
Attorneys for Panda Gila River, L.P.

Larry F. Eisenstat
Frederick D. Ochsenhirt
Dickstein Shapiro Morin & Oshinsky, LLP
2101 L Street, NW
Washington, DC 20037
Attorneys for TPS GP, Inc., a general partner of Panda Gila River, L.P.

ORIGINAL +10 copies of the foregoing delivered this 19th day of March, 2002 to:

Docket Control
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona

COPY delivered this day to:

Chairman William Mundell
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Commissioner Jim Irvin
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Commissioner Marc Spitzer
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Hercules Dellas, Aide to Chairman Mundell
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Patrick Black, Aide to Commissioner Irvin
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Paul Walker, Aide to Commissioner Spitzer
Arizona Corporation Commission
1200 W. Washington St.
Phoenix, AZ 85007

Lyn Farmer
Chief Administrative Law Judge
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona

Chris Kempley
Chief Counsel
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona

Ernest Johnson
Utilities Director
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona

COPY mailed this day to:

Scott S. Wakefield
RUCO
2828 N. Central Ave., Ste. 1200
Phoenix, AZ 85004

Greg Patterson
245 West Roosevelt
Phoenix, AZ 85003
Arizona Competitive Power Alliance

Walter W. Meek, President
Arizona Utility Investors Association
2100 N. Central Ave., Ste. 210
Phoenix, AZ 85004

Lawrence V. Robertson, Jr.
MUNGER CHADWICK, PLC
333 North Wilmot, Ste. 300
Tucson, Arizona 85711
Southwestern Power Group, LLC
Toltec Power Station, LLC
Bowie Power Station, LLC
Sempra Energy Resources

Roger K. Ferland
QUARLES & BRADY STREICH LANG, LLP
Renaissance One
Two North Central
Phoenix, Arizona 85004-2391
PG&E National Energy Group

Steven J. Duffy
RIDGE & ISAACSON
3101 N. Central Ave., Ste. 1090
Phoenix, AZ 85012

Steve Lavigne
Director of Regulatory Affairs
Duke Energy
4 Triad Center, Ste. 1000
Salt Lake City, UT 84180

Robert S. Lynch
Arizona Transmission Dependent Utility Group
340 E. Palm Lane, Ste. 140
Phoenix, AZ 85004-4529

Dennis L. Delaney
KR Saline & Associates
160 N. Pasadena, Ste. 101
Mesa, AZ 85201-6764

Thomas L. Mumaw
Jeffrey B. Guldner
SNELL & WILMER
One Arizona Center
Phoenix, AZ 85004
Arizona Public Service Company

Michael L. Kurtz
BORHM, KURTZ & LOWRY
36 E. Seventh Street, Ste. 2110
Cincinnati, OH 45202

By Mary Ann Hansen

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