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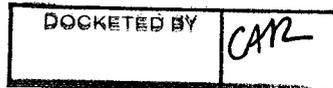
July 23, 2002

Arizona Corporation Commission  
**DOCKETED**

AZ CORP COMMISSION  
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JUL 23 2002

Commissioner Marc Spitzer  
Arizona Corporation Commission  
1200 West Washington Street  
Phoenix, Arizona 85007



**Re: Docket Nos. E-00000-02-0051, E-01345-01-0822, E-00000A-06-0630,  
E-01933A-02-0069 and E-01933A-98-0471 Generic Proceeding to  
Electric Restructuring**

Dear Commissioner Spitzer,

We appreciate your letter of July 18, 2002, and thank you again for restating your "deep commitment to wholesale electric competition." While the parties to date have not succeeded in settling the issues with Arizona Public Service Company ("APS"), Panda Gila River L.P., shares your belief that the time is now ripe to reach resolution and consensus on a number of the outstanding issues. We believe that your timely letter will help renew the Parties' attempts to do so.

In this regard, Panda Gila River could support a delay in APS's generation divestiture, a concurrent delay in implementing full competitive procurement and your proposed delay of retail competition under the conditions set forth below. Additionally, Panda Gila River would like to clarify some of the issues surrounding the subject of transmission availability and incremental transmission capacity additions.

*Divestiture/Competitive Solicitation*

APS's original variance request supported the divestiture of its generation assets to its affiliate, but also sought approval of a long-term power purchase agreement between Pinnacle West (i.e. the entity that would own both the divested utility generators and the non-utility generators, Redhawk and West Phoenix) and APS. That PPA would have tied up the vast majority of APS's load for up to 28 years.

Chairman Post's letter of July 11<sup>th</sup> proposed the regulatory opposite but functional equivalent of the original variance: no asset divestiture, keep the existing utility generators in APS's rate base, and, most significantly, **add** Pinnacle West's \$1 billion private investment in the Redhawk and West Phoenix plants to APS's rate base. It is Pinnacle West's July 11<sup>th</sup> proposal

that you suggest offers "a means by which this Commission can resolve the transfer and separation of assets issue."

Panda Gila River has always been flexible on the extent and timing of a competitive procurement process for the standard offer ratepayers. Indeed, our consistent position has been that both the timing and the extent of any such procurement should be determined during the course of the Track B proceeding. The flexibility we have publicly suggested was to allow participation by competitors with staggered on-line dates well into 2005 in combination with divestiture. We are, and have been open to other forms of flexibility including staggered dates for the competitive solicitations themselves. In fact, our closing brief suggested alternatives to 100% competitive solicitation if divestiture of APS's generation was not the path the Commission wished to follow. Panda Gila River has privately presented a number of other alternatives. We outline one of those alternatives herein to respond positively to your apparent belief that we have maintained "an intractable position vis-à-vis the amount and timing of competitive solicitation."

The only point on which Panda Gila River has stood firm throughout these consolidated proceedings is that Arizona standard offer ratepayers must be afforded the opportunity to get the best deal possible in terms of price, risk, reliability and environmental performance. It is because of this point that we find ourselves in disagreement with Chairman Post's letter of July 11<sup>th</sup>. If Pinnacle West simply rolls into APS's rate base its \$1 billion investment in its Redhawk and West Phoenix merchant plants, Arizona's ratepayers have no assurance they are getting the best deal. Moreover, as a matter of traditional regulatory process, the Commission would have failed to assure that these additions to APS's rate base are prudent and in the public interest. Like APS's PPA proposal, this latest proposal could also tie up the vast majority of APS's load for many years.

A compromise we would suggest for consideration follows from our willingness to be flexible, our concern that Arizona's standard offer ratepayers be protected, and our belief that without meaningful competition, long term generation investment in Arizona surely will be reduced. Specifically, we suggest a phased competitive solicitation approach with the first phase of the solicitation to be in an amount equal to (1) the capacity of the Redhawk and West Phoenix plants, plus (2) APS's incremental load growth, plus (3) the capacity of certain of APS's older plants that should be replaced as soon as possible by newer, cleaner units.<sup>1</sup>

So that APS's ratepayers are assured the best deal, we continue to suggest that bid responses from generators with on-line dates as early as 2003 and as late as 2005 be allowed in this first phase of solicitations. Exhibit A outlines our recommended solicitation plan resulting in a phased approach to full competition. The details of these competitive solicitations can be worked out at the Track B Technical Conference at which Panda Gila River expects to propose a number of innovative possibilities. Moreover, since prudence requires that an investment be compared to known and knowable alternatives before being placed in APS's rate base, the competitive solicitation itself would best constitute the test for prudence.

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<sup>1</sup> The total Mws associated with such aged and highly polluting plants remain to be determined. Without these Mws, the amount to be competitively solicited during the first phase equates to approximately 2,000 Mw.

One final point on generation divestiture on which there should be no misunderstanding. Other than their corporate affiliation with APS, Redhawk and West Phoenix are no different from the other IPP plants that were built in this state, including our own, in that: 1) they are merchant plants; 2) they were built at private, not ratepayer, risk; and 3) they do not own transmission or have rights to transmission service, other than such rights as they have to date, legally secured. Hence, following the reasoning of your letter, Redhawk and West Phoenix "are not 'public service corporations'" and are no more entitled to protection than any other merchant generator. In any event, it also is clear that moving these assets to the regulated utility would both further delay the advent of meaningful wholesale competition in the state, and would saddle the ratepayers with a new \$1 billion investment.<sup>2</sup>

Again, it is the goal of getting the best deal for Arizona ratepayers that should drive the Commission's approval of any competitive procurement process. Frankly, with more than 6,500 MW in construction, there will be a glut of capacity in Arizona. By ordering a solicitation process, the Commission will enable Arizona ratepayers to secure for many years into the future the benefits of today's buyer's market.

#### *Transmission*

A principal reason stated in your letter for the delay needed in launching competitive procurement is "the failure of IPPs to invest in solutions to Arizona's transmission constrained areas (the same areas in which they proclaim a desire to serve)." In fact, a considerable percentage, if not the majority, of the investments in the state over the past five years in transmission upgrades has been by IPPs. Panda Gila River, for example, has already spent more than \$50 million to fund transmission upgrades. During next week's Biannual Transmission Planning Update Workshops, and in our updated CEC filing later this year, we will provide further details on our transmission status and as to major new upgrades in the state that Panda Gila River expects to propose to fund, as necessary, to relieve congestion throughout the statewide system.

Under current FERC transmission pricing policy, IPPs pay transmission upgrade costs up front, and recover these expenses through transmission credits when transmission service begins. The intent is to treat generator-funded system upgrades the same as utility-funded upgrades (which are rolled into transmission rate base). Consequently, it makes little business sense for a generator to commit to significant transmission upgrades unless the generator is sure that a market for its output exists, which will lead to use of the upgrades and recovery of the upgrade costs through credits. Therefore, so long as the future of the Competition Rules remains in doubt, some generators will likely be less willing to fund certain transmission upgrades. Once it

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<sup>2</sup> Chairman Post's letter indicates that the Pinnacle West assets were "constructed or being constructed to serve APS." No more so than ours. In addition, the letter asserts that "the only place Pinnacle West Energy could obtain financing for this construction prior to divestiture was from Pinnacle West Capital Corporation." Why? The Panda Gila River project, representing more megawatts and a larger capital investment than the Pinnacle West facilities, closed its non-recourse project financing over a year ago.

is clear that generators will be able to compete for Standard Offer Service requirements, the level of generator-funded transmission upgrades will likely increase.

However, these major new investments in the state's infrastructure (made, again, with private, not ratepayer, dollars) should not be conditions precedent to APS opening its load to wholesale competition, for the simple reason that presently there is sufficient transmission capacity available on APS's transmission system to serve its native load using any interconnected generator, whether that generator is affiliated or not. See Hearing Tr. 1108. Currently, APS like all integrated utilities, reserves significant capacity on its transmission system to serve its native load. But this transmission capacity belongs to the load, not to APS.

Under the Competition Rules, APS would merely substitute the winning bidder in a competitive solicitation for an existing network resource, delivering power using the same transmission capacity that it currently uses to serve its customers. No additional transmission upgrades would be required, provided the generator could deliver its output to the APS system. Moreover, we would have no objection to requiring the winner of the solicitations, whether it is APS's affiliate Pinnacle West or any of the other unregulated IPPs, to commit to finance the expansion of the APS transmission system, if such investment is necessary to assure reliability. We think this is the commitment that can move the process forward while assuring the level of reliable service that Arizona's standard offer consumers deserve.

#### *Retail*

As we have noted in previous submissions in this docket: (a) Panda Gila River is not in the retail business, and (b) it is necessary to "get wholesale competition right" before proceeding to retail deregulation. For these reasons, we support your proposed delay in launching retail competition. A reasonable transition to the implementation of retail deregulation is required, but this should not impede the advent of wholesale competition as we have advocated here.

#### *Conclusion*

As your letter acknowledges, "Independent Power Producers ("IPPs") have invested hundreds of millions of dollars in Arizona . . ." Panda Gila River alone will have invested more than \$1.2 billion in four state-of-the-art, environmentally-friendly, gas-fired generating units when its facility is complete next year. That investment was made without any risk to Arizona's ratepayers.

Your recent letter reinforces your commitment to a competitive, fair wholesale electric market. Your leadership in this regard over the past year is deeply appreciated by all parties who share your vision of the future. As you note in your letter, the best future for Arizona is a "wholesale electric market [which] is fair, and in which modern, efficient and clean generation replaces aged and highly polluting plants . . ." We believe that the proposal set forth above provides a very workable framework for accomplishing your vision. A competitive, fair wholesale electric market is all Panda Gila River has sought, since it intervened in these dockets to stop APS's self-dealing PPA. That PPA would have limited competition to little more than incremental load growth of approximately 270 MW a year, load which, from a ratepayer

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perspective, should be competitively procured under any circumstance. The proposed PPA would also have protected APS's affiliate's generation by allowing it to serve APS's Standard Offer Service customers without being tested against the competitive market. This, despite the fact that the Electric Competition Rules required, and APS committed to, just the opposite, 100% competitive procurement as the quid pro quo for its desired generation asset divestiture.

Panda Gila River applauds your push to move the parties toward consensus. As has been the case so far, Panda Gila River looks forward to being an active participant in these discussions and in the Track B process. While the dictates of Rule 408 prohibit disclosure of specific discussions between the parties, as we note above, discussions have been held. What also can be said about those discussions is that Panda Gila River never walked away from these discussions or otherwise did anything to limit their utility. Panda Gila River remains ready and willing to continue discussions toward a competitive marketplace that meets the ratepayer protection concerns outlined in your recent letter. However, Panda Gila River will remain steadfast in its opposition to protecting APS's affiliated generation from competition, whether that be in the form of a non-competitive PPA or by moving those assets into APS's rate base without a market test.

Simply put, as you noted in your recent communication, the interests of even "public-service corporation stockholders must not be permitted to overshadow those of the public served." Arizona Community Action Ass'n v. Arizona Corporation Commission, 123 Ariz. 228, 231, 599 P.2d 184 (1979). But protection of stockholder interests on the backs of Arizona's ratepayers appears to be precisely what Pinnacle West now has proposed. Hence, we have proposed what we believe to be a fair middle ground. It is our hope that Pinnacle West and APS will accept our proposed framework or suggest a better approach from the standpoint of Arizona ratepayers.

Sincerely,



Panda Gila River, L.P.

cc: Chairman William A. Mundell  
Commissioner Jim Irvin  
All Parties on the Official Service List

EXHIBIT A

SUMMARY OF PHASED COMPETITIVE SOLICITATIONS

Date RFP Issued	In-Service Date(s)	APS MW, Cost-Plus Regulation		Competitively Procured MW <sup>2</sup>		Total MW (excluding load growth)	Percent Competitively Procured <sup>3</sup>	Percent Cost-Plus Regulation
		Base	With Reserves	End of Period Total <sup>4</sup>	With Reserves			
Fall 2002 <sup>1</sup>	Jan 2003 to	6,000	6,900			6,900	0%	100%
	Dec 2005	4,000	4,600	2,000 plus load growth	2,300 plus load growth	6,900	33%	67%
Spring 2004	Jan 2005 to				-			
	Dec 2007	2,000	2,300	4,000 plus load growth	4,600 plus load growth	6,900	67%	33%
Spring 2007	Jan 2008 to	2,000	2,300		-			
	Dec 2010	-	-	6,000 plus load growth	6,900 plus load growth	6,900	100%	0%

<sup>1</sup> Pinnacle West (or APS) will be permitted to bid Redhawk and the new West Phoenix units.

<sup>2</sup> Load Growth and capacity from aged and highly polluting plants not shown, but it too will be competitively procured.

<sup>3</sup> If Pinnacle West (or APS) wins any solicitation, it would be treated like any winning bidder and would sign a pay-for-performance PPA and would be included in the percent competitively procured.

<sup>4</sup> Numbers do not include Mws associated with aged and highly polluting plants.