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BEFORE THE ARIZONA CORPORATION COMMISSION P 12:30

Arizona Corporation Commission

WILLIAM A. MUNDELL
CHAIRMAN
JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER

DOCKETED

JUL 10 2002

AZ CORP COMMISSION
DOCKET CONTROL

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IN THE MATTER OF THE GENERIC) DOCKET NO. ~~E-00000A-02-0051~~
PROCEEDING CONCERNING ELECTRIC)
RESTRUCTURING ISSUES)

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

IN THE MATTER OF THE GENERIC) DOCKET NO. E-00000A-01-0630
PROCEEDING CONCERNING THE ARIZONA)
INDEPENDENT SCHEDULING)
ADMINISTRATOR)

IN THE MATTER OF TUCSON ELECTRIC) DOCKET NO. E-01933A-02-0069
POWER COMPANY'S APPLICATION FOR A)
VARIANCE OF CERTAIN ELECTRIC)
COMPETITION RULES COMPLIANCE)
DATES)

IN THE MATTER OF THE APPLICATION OF) DOCKET NO. E-01933A-98-0471
TUCSON ELECTRIC POWER COMPANY FOR)
APPROVAL OF ITS STRANDED COST)
RECOVERY)

RELIANT RESOURCES, INC.'S POST HEARING BRIEF

In compliance with the instructions of Administrative Law Judge Lynn Farmer ("ALJ Farmer" or the "ALJ"), Reliant Resources, Inc. ("Reliant") files its post

1 hearing brief setting forth Reliant's position on the four issues addressed in this
2 proceeding: Transfer of Assets; Market Power; Codes of Conduct and Jurisdiction.

3
4 **I. BACKGROUND AND PROCEDURAL HISTORY**

5 The Arizona Corporation Commission (the "Commission") adopted Retail
6 Competition Rules effective on or about December 26, 1996. The Rules provided the
7 framework for Arizona to transition from traditional regulated monopoly to a
8 competitive electric industry. Subsequently, the Rules were amended and re-adopted
9 in whole or in part and the implementation of many of the provisions of the Rules
10 have been delayed, by amendment, settlement or variance. Under the Rules, as
11 amended by individual settlements, both Tucson Electric Power Company ("TEP")
12 and Arizona Public Service Corporation ("APS") are required to divest their
13 competitive generation assets no later than January 1, 2003. See, A.A.C. R14-2-
14 1615.A. APS and TEP had the option of divesting to an affiliated entity or to third
15 parties. Both APS and TEP have elected to divest to an affiliated entity.
16 Additionally, A.A.C. R14-2-1606(B) and the Settlements require all power purchased
17 after January 1, 2003 by APS and TEP for Standard Offer Service must be acquired
18 from the competitive market through prudent, arm's length transactions, with at least
19 50% acquired through a competitive bid process.
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23 On October 18, 2001, APS filed a Request for a Partial Variance to A.A.C.
24 R14-2-1606(B) and for Approval of a Purchase Power Agreement. This Request
25 sought Commission authorization for APS to enter into a long-term (13 years), with
26

1 three five year options) purchase power agreement with its affiliate, Pinnacle West
2 Energy Corporation ("PinWest"). TEP also filed a request for a variance from a
3 portion of the Competition Rules. The Commission held a Special Open Meeting on
4 April 25, 2002, to consider an Order to Show Cause filed by Panda Gila River, LP
5 requesting the Commission order APS to proceed with implementing the requirements
6 of Rule 1606(B), as well as to consider other issues raised by the Commissioners and
7 Commission Staff regarding the propriety of staying APS' Variance Request until
8 certain other threshold issues were decided. During the Commission's Special Open
9 Meeting, the Commissioners stayed APS' variance hearing, which was scheduled to
10 begin on April 29, 2002, and ordered the Hearing Division to issue a Procedural Order
11 to address certain threshold issues on an expedited basis. Proceedings on TEP's
12 variance request were also stayed by a May 2, 2002 Procedural Order.
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16 On April 29, 2002, a procedural conference was held in this generic docket to
17 discuss how to proceed with the issues identified by the Commissioners at the Special
18 Open Meeting. A Procedural Order was issued May 2, 2002 dividing the proceeding
19 into Track A to consider the issues related to the transfer of assets and associated
20 market power issues, issues regarding the Code of Conduct, the Affiliated Interest
21 Rules, and the jurisdictional issues and Track B to consider issues associated with the
22 competitive solicitation process needed to implement Rule 1606(B). A procedural
23 schedule was developed to address the Track A issues that include the filing of direct
24 testimony on May 29, 2002, the filing of rebuttal testimony on June 11, 2002 and a
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1 public hearing from June 17-21, 2002, and June 27-28, 2002. A Recommended Order
2 is expected on Track A issues on July 22, 2002, with exceptions thereto due July 31,
3 2002. Reliant is a party to these proceedings and filed the direct testimony of Curtis
4 Kebler on May 29, 2002 (Reliant-1).
5

6 **II. MARKET POWER AND RELIANT'S MARKET-BASED SOLUTION**

7 All parties, with the exception of APS and possibly the Arizona Utility
8 Investors Association, recognize that the transfer of all UDC generation assets to an
9 affiliate will result in a concentration of market resources that provide the opportunity
10 for the affiliate to exert market power on the wholesale generation market. *See, e.g.,*
11 Neil Talbot, Direct Testimony (S-6) at 14:12-13; David Schlissel, Direct Testimony
12 (S-8) at 2:15-17; Dr. Richard Rose, Rebuttal Testimony (RUCO-2) at 2: 8-13; Curtis
13 Kebler, Direct Testimony (Reliant-1) at 2:14-15; Dr. Craig Roach, Direct Testimony
14 (Panda-1) at 3:21-23; Thomas Broderick, Rebuttal Testimony (HGC-1) at 7: 4-7; and
15 Kevin Higgins, Direct Testimony (AECC-2) at 14:3-5.
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18 As recognized by Staff witness, Neil H. Talbot:

19
20 [T]he Arizona market is significantly *less* competitive than
21 the regional market. Firstly, it is vulnerable to recurrences of
22 regional problems that could result in regional shortages or
23 price spikes. More importantly, however, the Arizona
24 market is limited by transmission constraints that protect
25 local generators against outside competitors. It is therefore
26 less competitive, at least during some seasons and times of
day.”

1 There are two sets of local issues that are critical in
2 restructuring. One is the adequacy or inadequacy of local
3 transmission and generation capacity to diminish *horizontal*
4 market power in the Arizona market. The other is the
5 problem of *vertical* market power resulting from the
6 ownership of transmission and generation facilities by
affiliates of the Utility Distribution Companies (UDCs). The
Commission has considerable authority over these two sets
of issues.

7 Direct Testimony of N. Talbot (S-6) at 12:9-21.

8 While the parties come to different conclusions on the character and existence
9 of market power, there is little doubt that the transfer of assets results in a
10 concentration of generation within a single competitive entity in Arizona. This is
11 particularly true in the State's load pockets where a large portion of load is served (Tr.
12 (Vol. I) at 76-77:19-25,1; Tr. (Vol. I) at 77:14-17). Whether or not the Commission
13 determines this is "market power" in a legal sense, it is obvious that without some
14 form of mitigation or boundary in the short-term, the incumbent utilities will be able
15 to significantly influence the price of electricity in any competitive procurement (Tr.
16 (Vol. III) at 723:12-22).

17 In order to address concerns regarding the transfer of utility assets to an
18 affiliate generating company and the associated market power issues, Reliant witness
19 Curtis Kebler offered a two-pronged market-based proposal. Specifically, the
20 proposal alleviates short-term concerns regarding a utility affiliate holding a highly
21 concentrated amount of generation assets. Reliant's approach also addresses concerns
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1 over existing transmission constraints that limit the amount of external generation that
2 can be imported into certain Arizona load pockets.

3 The first step involves a capacity auction in which wholesale market
4 participants are able to acquire a specified portion of the output of the capacity
5 transferred by the UDC to an affiliate. The asset itself is not sold in this type of
6 auction, only an entitlement to a portion of the output for a period of time. Once the
7 entitlement to a portion of the existing generation capacity has been diversified among
8 multiple market participants, these participants can then compete in the process
9 envisioned under Rule 1606(B) to provide generation services to APS and its
10 Standard Offer customers.
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13 Rule 1606(B) requires the utilities acquire at least 50% of its Standard Offer
14 power supplies through a competitive bid process. The second step in Reliant's
15 proposal recommends the competitive solicitation process be structured as "slice of
16 system" auctions. Bidders would be competing on the basis of price to provide a
17 specific percentage of APS' daily load requirement. Under this auction procedure,
18 APS would be purchasing a fixed priced product. The contract lengths would vary
19 under this proposal. In addition, Reliant recommends that the power contracts
20 acquired under the competitive solicitation process and arm's length bilateral
21 transactions have staggered delivery dates and varying contract lengths be staggered
22 to increase competition and encourage participation by new or expanding suppliers.
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1 As described by Reliant witness Kebler, this proposal is significant because it
2 demonstrates a potential market-based solution to the concerns raised in Track A (Tr.
3 (Vol. III) at 846:13-22). While details of the Reliant proposal are appropriate to
4 discuss in "Track B" of this proceeding, the proposal is also relevant to Track A. The
5 Commission must recognize that on the one hand decisions made in Track A will
6 directly influence the direction of Track B and, on the other hand, the competitive
7 procurement process(es) established in Track B can, and should be used to address
8 and alleviate concerns raised in Track A. In fact, Reliant's proposal affords the
9 Commission an alternative that addresses the issues arising from the concentration of
10 generation in one or more UDC affiliates, yet avoids unnecessary delay in the
11 implementation of competition for Arizona's Standard Offer load. As a result,
12 consumers will receive the benefits of competition in a timely manner. The capacity
13 auction allows a greater diversity of suppliers to participate in the market for Standard
14 Offer load. As new generation is built and new transmission relieves delivery
15 constraints, the need for a capacity auction will diminish.

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19 In contrast, permitting the incumbent utilities to divest their generation assets
20 to affiliates without the appropriate competitive solicitation procedures in place and
21 underway, as required by Rule 1606(B), will severely jeopardize the long-term
22 viability of competition among wholesale suppliers in Arizona. Such a decision
23 would effectively deny or unreasonably delay Arizona's consumers the benefits
24 provided by vigorous competition.
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1 **III. RELIANT RESOURCES, INC.'S POSITION ON THE OTHER**
2 **SUBSTANTIVE ISSUES IN TRACK A**

3 **A. Reliant Supports Proceeding With Wholesale Competition Sooner**
4 **Rather Than Later.**

5 Like nearly all of the parties in this proceeding, Reliant supports a robust and
6 competitive wholesale market for electricity in Arizona. Like the Commission,
7 Reliant also supports getting competition right and creating a success story. Reliant
8 believes the current competition Rules provide the appropriate framework for a
9 successful transition to competition. Reliant has provided the Commission with a
10 market-based solution to many of the concerns brought forth by the Commission,
11 Staff, and several intervenors that can be implemented without amending any of the
12 Rules¹. This constructive framework should be used as the basis for resolution to the
13 utilities' desire to divest their generating assets, the Commission's desire to provide
14 stable and efficient electricity prices, and the wholesale electricity suppliers' desire
15 for the opportunity to provide Standard Offer load service to the State's UDCs at
16 competitive prices.
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19 **B. Reliant Supports The Transfer Of Assets, Provided A Transparent**
20 **Competitive Solicitation Process Is In Place And Underway.**

21 Throughout this proceeding Reliant has supported the transfer of incumbent
22 utility generation assets to its affiliate. Reliant believes this is the appropriate
23

24 ¹ Reliant believes extensions of compliance deadlines, if any are required, and placement of
25 conditions on the transfer of assets (e.g., requiring a capacity auction) can be accomplished
26 through Orders involving specific utilities, after notice and opportunity to be heard.

1 approach to facilitate a vibrant competitive wholesale market in Arizona. However, it
2 is of the utmost importance that the Commission permit divestiture to proceed only in
3 conjunction with competitive procurement for the Standard Offer load as required in
4 1606(B).
5

6 The majority of the parties to this proceeding also agree that divestiture is
7 appropriate, and further believe the competitive procurement required by Rule
8 1606(B) is a necessary and fundamental condition precedent to any divestiture. Any
9 approach that permits divestiture without implementing competitive procurement at
10 the wholesale level, on a fair and transparent basis as envisioned by Rule 1606(B),
11 places at risk the long-term viability of the existing and new generation projects
12 constructed to serve the region's electrical demand. Without these projects, the State's
13 retail consumers cannot be offered the significant benefits associated with a healthy
14 competitive wholesale market.
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17 APS contends divestiture must proceed because divestiture is part of a
18 settlement agreement approved by the Commission (APS-1 at 5:11-23). Yet,
19 through its proposed PPA, APS seeks to alter the fundamental conditions on which
20 the transfer was based—competition under Rule 1606(B). In fact, APS seeks to
21 extend the protection of regulation to assets build by its affiliates (e.g., Redhawk and
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1 West Phoenix), while maintaining the option of using the same assets to compete on
2 the market. This must not be allowed.²

3 By requesting a variance to this rule, APS effectively stagnates the wholesale
4 market in Arizona. This is in stark contrast to their claim that the divestiture and
5 long-term PPA will enhance competition within Arizona (APS-4 at 18-19:19-23,1-4).
6 In fact, APS/PinWest witness Davis readily admits that the PPA results in an
7 additional 13 years of cost-of-service rates without any competitive market test (Tr.
8 (Vol. I) at 95:17-23). Considering the contract renewals of the PPA, the actual length
9 of continued cost-of-service may be closer to 28 years. Staff witness Schlissel
10 rightfully points out that the PPA is a "cost-plus proposal" (Tr. (Vol. VI) at 1400:10-
11 11). This realization further displays that the benefits of competition will not be
12 available to Arizona's ratepayers as the APS Variance is currently proposed.

13 Panda witness Roach explained that a continuation of cost-of-service rates
14 presents measurable risks to the ratepayers that are reduced with the introduction of
15 competition for Standard Offer load (Panda-3 at 8:11-12; Tr. (Vol. III) at 753:21-25).
16 Reliant wholeheartedly agrees with Dr. Roach's assertion. Furthermore, approving
17 such a variance would be inappropriate for the Arizona ratepayer at this time

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24 ² Neither may Pinnacle West Energy be allowed to transfer these unregulated assets to APS, if
25 divestiture does not take place. These assets were build as competitive assets. Any non-
26 competitive transfer to APS will effectively eliminate the possibility of creating a robust
competitive wholesale market, and the benefits to retail customers associated therewith, for the
foreseeable future.

1 considering the number of parties in this proceeding that have expressed a desire to
2 serve Standard Offer load.

3
4 In light of the concern regarding the transfer of assets, Reliant has presented an
5 approach to competitive solicitation that encourages a vibrant market with many
6 active participants. Furthermore, our proposal provides for an efficient and
7 transparent market price to serve Arizona ratepayers. Varying contract lengths and
8 staggered delivery dates, as proposed by Reliant and others, significantly enhanced
9 the opportunity for vigorous competition to serve Standard Offer customers . The
10 Commission must recognize that these attributes preserve the spirit of 1606(B) and
11 provide stable electricity prices at competitive prices for ratepayers. Notably, the
12 Reliant proposal also allows APS to transfer its generating assets to Pinnacle West.
13

14
15 No party in this proceeding argued that Reliant's plan for a capacity auction
16 and load auction is undesirable. Only Harquahala (HGC-1 at 8:1-6) and RUCO
17 (RUCO-2 at 8:17-22) made any mention that they believe the current market
18 protocols do not support these market-based solutions. However, both parties agreed
19 that the proposals have merit and provided support for their use in the future (HGC-1
20 at 7:10-25; RUCO-2 at 8:17-22). Reliant agrees that protocols will need to be
21 established to fully implement our plan. However, Reliant strongly believes that
22 protocols can be established in short order through stakeholder workshops and still
23 allow Arizona's utilities to meet the requirements of 1606(B), sooner rather than later.
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1 Expedition of this process is possible. For example, APS' witness Davis
2 discussed that the company already has the ability to receive or deliver power with
3 third parties (Tr. (Vol. I) at 145:2-11). The protocols currently used for these
4 deliveries can be utilized as a basis for protocols in stakeholder workshops to be held
5 upon the completion of this docket. While this will take intense work on the part of
6 all involved, it is a process that can produce positive results for Arizona's Standard
7 Offer customers.
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10 The inclusion of competitive procurement with any approval of the transfer of
11 assets is paramount to the success of Arizona's competitive wholesale electricity
12 market. As several parties pointed out, the transfer-and-PPA proposal of APS only
13 leads to non-competitive prices for up to 28 years for a large number of Arizona
14 ratepayers. This should not be an acceptable outcome for the Commission when
15 superior market-based proposals are available.
16

17 Several parties presented the Commission with different plans for an
18 appropriate method of the transfer of assets from the incumbent utility to its affiliate.
19 Staff witness Schlissel (S-8 at 2:24-26) and RUCO witness Rosen (RUCO-1 at 47:13-
20 22) both support additional market power analyses prior to divestiture. The record
21 already has at least two market power studies plus additional insightful information
22 from numerous witnesses to these proceedings. Further, market power studies are
23 therefore unnecessary. Indeed, Reliant has proposed a market-based solution that
24 abrogates the need for additional market power studies.
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1 The Track A hearings produced support for a significant portion of Standard
2 Offer load to be competitively procured today (Tr. (Vol. IV) at 978-979:25,1-3).
3 Additionally, Reliant has proposed a balanced market-based alternative to address
4 market power concerns. Yet, Reliant realizes that current time constraints may lead
5 the Commission to conclude that an altered schedule or arrangement is appropriate to
6 achieve the requirements of Rule 1606(B). This might include the staggered transfer
7 of assets from the utility to a generation company affiliate. In turn, the amount of
8 Standard Offer load available for competitive bid could be phased-in incrementally.
9 In the event an additional phase-in period is ordered, the Commission must also
10 provide a clear and firm framework to ensure Arizona continues to move toward
11 competition expeditiously. Otherwise, the Commission risks foreclosing meaningful
12 wholesale competition and the benefits to retail customers that flow therefrom for the
13 foreseeable future. The failure to continue toward wholesale competition will also
14 unduly penalize the merchant generators who have responded to the Commission's
15 invitation to compete in Arizona. These adverse consequences arise because the
16 incumbent utilities have not adequately prepared to implement Rule 1606(B).

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21 **C. Affiliate Transactions And The Code Of Conduct Must Be**
22 **Strengthened To Ensure A Level Playing Field.**

23 Staff proposes a process to establish new codes of conducts for transactions
24 between a utility and its energy-services related businesses (Staff-11 at 7:11-26).
25 Staff witness Keene believes that the proposed Code of Conduct fills a void in the
26

1 rules and codes currently in place between a utility and its affiliates (Tr. (Vol. VI) at
2 1445:19-24). Reliant concurs that further consideration of Arizona's Code of
3 Conduct is appropriate to ensure ratepayers do not subsidize any non-regulated
4 competitive operations. The Code of Conduct is an important element for the
5 development of a level-playing field for wholesale competitors in the State.
6

7 While Reliant agrees that several different sets of affiliate transaction rules and
8 codes of conducts from different regulatory bodies are currently in place and apply to
9 Arizona's utilities, Staff's proposal appears to address concerns outside of the current
10 applicable rules. With the alterations in language as found in Staff-12, Reliant
11 believes there is an appropriate starting point for a new Code of Conduct.
12

13 Reliant also believes that the corrections provided in Staff-12 concerning the
14 pricing of transfers or sales between the utility and affiliate brings closure to many of
15 the arguments against an updated Code of Conduct. For example, APS witness
16 Cicchetti had argued against the pricing recommendation that was subsequently
17 removed from the Staff's corrected comments (APS-3 at 26-27:22-24,1-2). With this
18 matter resolved, or at the very least reserved for a more appropriate forum, there is
19 little incentive to argue against Staff's recommendation.
20

21 The development of the new Code of Conduct must not be allowed to cause a
22 material delay in the competitive procurement of Standard Offer load. Such a delay
23 will only cause uncertainty for the market and stall the benefits of competition that
24 would otherwise be available to Arizona's Standard Offer customers.
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1 **D. Jurisdictional Issues Should Not Halt Implementation Of**
2 **Competition**

3 The Commission, Staff, and other parties have shown significant concern over
4 the placement of jurisdiction over generation assets in Arizona that are divested from
5 the incumbent utility to an affiliate. In particular, concerns have been raised
6 regarding the status of WestConnect (Tr. (Vol. I) at 237:19-20). The record
7 adequately covers the status of WestConnect and the market monitoring functions of
8 Regional Transmission Organizations (RTO). Furthermore, APS' witness
9 Hieronymus (Tr. (Vol. IV) at 993:6-14), recognizes the likelihood of WestConnect
10 being approved as a for-profit RTO is highly unlikely given FERC's recent decision
11 regarding the Alliance in the Midwest³.

12 The Commission and Staff's greater concern appears to be the transfer of
13 jurisdiction over the generation assets from the Commission to FERC when
14 divestiture occurs and the ability of FERC to create and monitor appropriate
15 safeguards to minimize risks to retail customers. The testimony of Staff witness, Paul
16 Peterson demonstrates FERC is proactively implementing appropriate safeguards to
17 protect electric consumers at the wholesale level. The Commission should not stifle
18 competition just because the record establishes that the former APS power plants have
19 gained Exempt Wholesale Generator status from FERC (Tr. (Vol. I) at 231:16-22) and
20 the proposed PPA would be a FERC-approved tariff (Tr. (Vol. I) at 232:7-11).

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26 ³ 97 FERC para 61,327 (2001).

1 Reliant agrees with the statement of Panda witness Roach regarding the ability
2 of the Commission to take proactive steps to control the mechanisms and inputs of
3 competitive solicitation so that these concerns may be allayed (Tr. (Vol. III) at 726:1-
4 8). In making a decision regarding these issues, the Commission must consider a
5 long-term vision for competition in Arizona. As many of the competitive suppliers in
6 this proceeding attested to, there is great interest in serving Arizona's Standard Offer
7 load. This is a positive signal that competition implemented under the existing rules
8 will produce an efficient and transparent outcome .
9
10

11 IV. CONCLUSION

12 No testimony was presented in this proceeding questioning either the wisdom
13 of moving toward competition or the benefits provided by competition. The
14 Commission must not reverse course now. It is imperative for the long-term success
15 of the wholesale market in Arizona that any transfer of assets from the utility to an
16 affiliate is done in conjunction with a plan for competitive solicitation as required in
17 Rule 1606(B). Reliant Resources has provided a market-based solution to these
18 matters that has been proven to be successful in other jurisdictions. Reliant's proposal
19 for capacity auctions and load auctions adheres to the requirements of 1606(B),
20 allows Arizona's utilities to transfer their generation assets to an affiliate, and
21 addresses the most important concerns explored in this proceeding. Furthermore,
22 Reliant's proposal addresses the parties' very real concern of market power in
23 Arizona with a solution that utilizes the market to mitigate the concentration of assets.
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Importantly, the Reliant proposal envisions a transparent and efficient market that will bring the benefits of competition to Arizona's consumers. To ensure that these consumers have access to these benefits, it is important that the Commission take the steps to facilitate this access as envisioned in the Electric Competition Rules.

RESPECTFULLY submitted this 10th day of July, 2002.

MARTINEZ & CURTIS, P.C.

By 
Michael A. Curtis
William P. Sullivan
Paul R. Michaud
2712 North Seventh Street
Phoenix, Arizona 85006-1090
Attorneys for Reliant Resources, Inc.

1 Original and eighteen (18) copies of the foregoing document filed with service list
2 this 10th day of July, 2002 with:

3 Docket Control
4 Arizona Corporation Commission
5 1200 West Washington Street
6 Phoenix, Arizona 85007

7 Copies of the foregoing hand-delivered without a copy of the service list
8 this 10th day of July, 2002 to:

9 William A. Mundell, Chairman
10 Arizona Corporation Commission
11 1200 West Washington Street
12 Phoenix, Arizona 85007

Ernest Johnson, Director
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

13 Jim Irvin, Commissioner
14 Arizona Corporation Commission
15 1200 West Washington Street
16 Phoenix, Arizona 85007

Lyn Farmer
Chief Administrative Law Judge
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

17 Marc Spitzer, Commissioner
18 Arizona Corporation Commission
19 1200 West Washington Street
20 Phoenix, Arizona 85007

Christopher Kempley, Chief Counsel
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

21 Hercules Dellas
22 Aide to Chairman Mundell
23 Arizona Corporation Commission
24 1200 West Washington Street
25 Phoenix, Arizona 85007

Jerry Smith
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

26 Kevin Barley
Aide to Commissioner Irvin
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Brian O'Neil, Executive Secretary
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Paul Walker
Aide to Commissioner Spitzer
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Steve Olea, Asst. Director
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

1 Copies of the foregoing mailed without copy of service list this 10th day of July, 2002 to:

2
3 JANA VAN NESS
AZ PUBLIC SERVICE CO
MAIL STATION 9905
P O BOX 53999
4 PHOENIX AZ 85072-3999
Jana.vanness@aps.com

LINDY FUNKHOUSER
SCOTT S WAKEFIELD
RUCO
2828 N CENTRAL AVE
SUITE 1200
PHOENIX AZ 85004

VICKI G SANDLER
C/O LINDA SPELL
APS ENERGY SERVICES
P O BOX 53901 MAIL STATION 8103
PHOENIX AZ 85072-3901
Linda_spell@apses.com

5
6 TOM WRAN
SOUTHWESTERN POWER GROUP II
7 Twray@southwesternpower.com

WALTER W MEEK PRESIDENT
AZ UTIL INVESTORS ASSOC
2100 N CENTRAL SUITE 210
PHOENIX AZ 85004

RICK GILLIAM
ERIC C GUIDRY
LAND & WATER FUND OF THE ROCKIES
2260 BASELINE RD SUITE 200
BOULDER CO 80302

8
9 TERRY FROTHUN
ARIZONA STATE AFL-CIO
5818 N 7TH ST SUITE 200
10 PHOENIX AZ 85014-5811

NORMAN J FURUTA
DEPT OF THE NAVY
900 COMMODORE DR
BLDG 107
SAN BRUNO CA 94066-5006

BARBARA S BUSH
COALITION FOR RESPONSIBLE ENERGY
EDUCATION
315 W RIVIERA DRIVE
TEMPE ARIZONA 85252

11
12 COLUMBUS ELECTRIC COOPERATIVE
INC
P O BOX 631
13 DEMING NM 88031

RICK LAVIS
AZ COTN GRWRS ASSOC
4139 E BROADWAY ROAD
PHOENIX AZ 85040

STEVE BRITTLE
DONT WASTE ARIZONA INC
6205 S 12TH STREET
PHOENIX AZ 85040

14
15 GARKANE POWER ASSOC INC
P O BOX 790
16 RICHFIELD UTAH 84701

CONTINENTAL DIVIDE
ELECTRIC COOPERATIVE
P O BOX 1087
GRANTS NM 87020

DIXIE ESCALANTE RURAL
ELEC ASSOC
CR BOX 95
BERYL UTAH 84714

17
18 TUCSON ELECTRIC POWER CO
LEGAL DEPT - DB203
220 W 6TH STREET
19 P O BOX 711
TUCSON AZ 85702-0711

AZ DEPT OF COMMERCE
ENERGY OFFICE
3800 N CENTRAL 12TH FL
PHOENIX ARIZONA 85012

AZ COMMUNITY ACTION ASSOC
2627 N 3RD ST SUITE 2
PHOENIX AZ 85004

20
21 JOE EICHELBERGER
MAGMA COPPER COMPANY
PO BOX 37
22 SUPERIOR AZ 85273

A B BAARDSON
NORDIC POWER
6463 N DESERT BREEZE CT
TUCSON AZ 85750-0846

JESSICA YOULE
PAB300
SALT RIVER PROJECT
P O BOX 52025
PHOENIX AZ 85072-2025

23
24 STEVE MONTGOMERY
JOHNSON CONTROLS
2032 W 4TH STREET
25 TEMPE AZ 85281

CRAIG MARKS
CITIZENS UTIL COMPANY
2901 N CENTRAL SUITE 1660
PHOENIX AZ 85012-2736

BARRY HUDDLESTON
DESTEC ENERGY
PO BOX 4411
HOUSTON TX 77210-4411

26

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LARRY MCGRAW
USDA-RUS
6266 WEEPING WILLOW
RIO RANCHO NM 87124

JOHN JAY LIST GENERAL COUNSEL
NATL RURAL UTIL COOP FIN CORP
2201 COOPERATIVE WAY
HERNDON VA 21071

ROBERT S LYNCH
340 E PALM LN SUITE 140
PHOENIX AZ 85004-4529

DOUGLAS NELSON
DOUGLAS C NELSON PC
7000 N 16TH ST SUITE 120-307
PHOENIX AZ 85020-5547

MICHAEL GRANT
GALLAGHER & KENNEDY
2575 E CAMELBACK ROAD
PHOENIX ARIZONA 85016-9225
Ming@gknet.com

VINNIE HUNT
CITY OF TUCSON
DEPARTMENT OF OPERATIONS
4004 S PARK AVE BLDG #2
TUCSON ARIZONA 85714

CARL DABELSTEIN
CITIZENS COMMUNICATIONS
2901 N CENTRAL AVE SUITE 1660
PHOENIX ARIZONA 85012

RUSSELL E JONES
WATERFALL ECONOMIDIS CALDWELL
HANSHAW & VILLAMANA PC
5210 E WILLIAMS CIR SUITE 800
TUCSON ARIZONA 85711
Rjones@wechv.com

TERRY ROSS
CENTER FOR ENERGY &
ECONOMIC DEVELOPMENT
PO BOX 288
FRANKTOWN CO 80116-0288

JIM DRISCOLL
AZ CITIZENS ACTION
5160 E BELLEVUE ST
APT 101
TUCSON AZ 85712-4828

ROBERT JULIAN
PPG
1500 MERRELL LANE
BELGRADE MT 59714

K R SALINE
K R SALINE & ASSOCIATES
CONSULTING ENGINEERS
160 N PASADENA SUITE 101
MESA AZ 85201-6764

LAWRENCE V ROBERTSON JR
MUNGER CHADWICK PLC
333 N WILMOT SUITE 300
TUCSON AZ 85711-2634
Lvrobertson@mungerchadwick.com

SUZANNE DALLIMORE
ANTITRUST UNITCHIEF
AZ ATTY GENERALS OFC
1275 W WASHINGTON
PHOENIX AZ 85007

RODERICK G MCDUGAL
CITY ATTY
CITY OF PHOENIX
ATTN JESSE SEARS
200 W WASHINGTON
STE 1300
PHOENIX AZ 85003-1611

CHRISTOPHER HITCHCOCK
HITCHCOCK & HICKS
PO BOX 87
BISBEE ARIZONA 85603-0087
Lawyers@bisbeelaw.com

CLARA PETERSON
AARP
HC 31 BOX 977
HAPPY JACK AZ 86024

C WEBB CROCKETT
JAY L SHAPIRO
FENNEMORE CRAIG PC
3003 N CENTRAL SUITE 2600
PHOENIX AZ 85012-2913

CARL ROBERT ARON
EXEC VP & COO
ITRON INC
2818 N SULLIVAN ROAD
SPOKANE WA 99216

ALBERT STERMAN
AZ CONSUMERS COUNCIL
2849 E 8TH STREET
TUCSON AZ 85716

RAYMOND S. HEYMAN
MICHAEL PATTEN
ROSHKA HEYMAN & DEWULF
400 E VAN BUREN SUITE 800
PHOENIX ARIZONA 85004
mpatten@rhd-law.com
rheyman@rhd-law.com

ELIZABETH S FIRKINS
INTL BROTHERHOOD OF ELECTRIC WORKS
LU #1116
750 S TUCSON BLVD
TUCSON ARIZONA 85716-5698

WILLIAM J MURPHY
CITY OF PHOENIX
200 W WASHINGTON SUITE 1400
PHOENIX ARIZONA 85003-1611
Bill.Murphy@phoenix.gov

TIMOTHY M HOGAN
AZ CENTER FOR LAW IN THE PUBLIC
INTEREST
202 E MCDOWELL RD SUITE 153
PHOENIX ARIZONA 85004

1
2
3
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BARBARA R GOLDBERG
OFFICE OF THE CITY ATTORNEY
3939 CIVIC CENTER BLVD
SCOTTSDALE ARIZONA 85251

MICHELLE AHLMER
AZ RETAILERS ASSOCIATION
224 W 2ND ST
MESA ARIZONA 85201-6504

TIMOTHY MICHAEL TOY
WINTHROP STIMSON PUTNAM & ROBERTS
ONE BATTERY PARK PLAZA
NEW YORK NY 10004-1490

MARCIA WEEKS
18970 N 116TH LANE
SURPRISE ARIZONA 85374

JOHN T TRAVERS
WILLIAM H NAU
272 MARKET SQUARE
SUITE 2724
LAKE FOREST IL 60045

STEPHEN L TEICHLER
STEPHANIE A CONAGHAN
DUANE MORRIS & HECKSCHER LLP
1667 K STREET NW STE 700
WASHINGTON DC 20006

STEPHANIE A CONAGHAN
DUANE MORRIS & HECKSCHER LLP
1667 K STREET NW SUITE 700
WASHINGTON DC 20006-1608

RAYMOND S HEYMAN
MICHAEL W PATTEN
ROSHKA HEYMAN & DEWULF
PLC
400 E VAN BUREN STE 800
PHOENIX ARIZONA 85004
rheyman@rhd-law.com

STEVEN C GROSS
PORTER SIMON
40200 TRUCKEE AIRPORT ROAD
TRUCKEE CA 96161-3307

BILLIE DEAN
AVIDD
PO BOX 97
MARANA AZ 85652-0987

RAYMOND B WUSLICH
WINSTON & STRAWN
1400 L STREET NW
WASHINGTON DC 20005

THERESA DRAKE
IDAHO POWER COMPANY
PO BOX 70
BOISE IDAHO 83707

DONALD R ALLEN
JOHN P COYLE
DUNCAN & ALLEN
1575 EYE STREET NW SUITE 300
WASHINGTON DC 20005

WARD CAMP
PHASER ADVANCED METERING
SVCS
400 GOLD SW SUITE 1200
ALBUQUERQUE NM 87102

JAMES P BARLETT
5333 N 7TH STREET
SUITE B-215
PHOENIX ARIZONA 85014

LIBBY BRYDOLF
CALIFORNIA ENERGY MARKETS
NEWSLETTER
2419 BANCROFT STREET
SAN DIEGO CALIFORNIA 92104

PAUL W TAYLOR
R W BECK
2201 E CAMELBACK RD
SUITE 115-B
PHOENIX AZ 85016-3433

KATHY T PUCKETT
SHELL OIL COMPANY
200 N DAIRY ASHFORD
HOUSTON TEXAS 77079

JAY I MOYES
MOYES STOREY LTD
3003 N CENTRAL AVE
SUITE 1250
PHOENIX ARIZONA 85012
Jimoves@lawms.com

ANDREW BETTWY
DEBRA JACOBSON
SOUTHWEST GAS CORP
5241 SPRING MOUNTAIN ROAD
LAS VEGAS NEVADA 89150-0001

PETER GLASER
SHOOK HARDY & BACON LLP
600 14TH STREET NW SUITE 800
WASHINGTON DC 20006-2004

ANDREW N CHAU
SHELL ENERGY SERVICES CO LLC
1221 LAMAR SUITE 1000
HOUSTON TEXAS 77010

PETER Q NYCE JR
DEPT OF THE ARMY
JALS-RS SUITE 713
901N STUART STREET
ARLINGTON VA 22203-1837

SANFORD J ASMAN
570 VININGTON COURT
DUNWOODY GA 30350-5710

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DAN NEIDLINGER
NEIDLINGER & ASSOCIATES
3020 N 17TH DRIVE
PHOENIX ARIZONA 85015

CHUCK GARCIA
PNM LAW DEPARTMENT
ALVARADO SQ MS 0806
ALBUQUERQUE NM 87158

HOLLY E CHASTAIN
SCHLUMBERGER RESOURCE MGMT
SERVICES INC
5430 METRIC PLACE
NORCROSS GA 30092-2550

PATRICIA COOPER
AEP/SSWEP/CO
POST OFFICE BOX 670
BENSON ARIZONA 85602
Pcooper@aepnet.org

ALAN WATTS
SOUTHERN CALIFORNIA
PUBLIC POWER AGENCY
529 HILDA COURT
ANAHEIM CA 92806

FREDERICK M BLOOM
COMMONWEALTH ENERGY CORP
15991 RED HILL AVE SUITE 201
TUSTIN CA 92780

LESLIE LAWNER
ENRON CORP
712 N LEA
ROSWELL NM 88201

KEVIN MCSPADDEN
MILBANK TWEED HANDLEY
AND MCCLOY LLP
601 S FIGUEROA 30TH FL
LOS ANGELES CA 90017

BRIAN SOTH
FIRSTPOINT SERVICES, INC.
1001 SW 5TH AVE SUITE 500
PORTLAND OREGON 97204

MARGARET MCCONNELL
MARICOPA COMMUNITY COLLEGES
2411 W 14TH STREET
TEMPE AZ 85281-6942

ROGER K FERLAND
QUARLES & BRADY STREICH
LANG LLP
RENAISSANCE ONE
TWO N CENTRAL AVENUE
PHOENIX AZ 85004-2391
rferland@quarles.com

M C ARENDES JR
C3 COMMUNICATIONS INC
2600 VIA FORTUNA SUITE 500
AUSTIN TEXAS 78746

IAN CALKINS
PHOENIX CHAMBER OF COMMERCE
201 N CENTRAL AVE 27TH FL
PHOENIX ARIZONA 85073

CHARLES T STEVENS
ARIZONANS FOR ELECTRIC
CHOICE & COMPETITION
245 W ROOSEVELT
PHOENIX ARIZONA 85003

STEVEN J DUFFY
RIDGE & ISAACSON PC
3101 N CENTRAL AVE SUITE 740
PHOENIX ARIZONA 85012

PATRICK J SANDERSON
AZ INDEPENDENT SCHEDULING
ADMINISTRATOR ASSOC
PO BOX 6277
PHOENIX ARIZONA 85005-6277
Psanderson@az-isa.org

JEFFREY GULDNER
SNELL & WILMER
ONE ARIZONA CENTER
PHOENIX AZ 85004-0001
jguldner@swlaw.com

STEVEN LAVIGNE
DUKE ENERGY
4 TRIAD CENTER SUITE 1000
SALT LAKE CITY UTAH 84180

MARK SIROIS
ARIZONA COMMUNITY ACTION
ASSOCIATION
2627 N THIRD STREET SUITE 2
PHOENIX ARIZONA 85004

JOHN WALLACE
GRAND CANYON STATE
ELECTRIC CO-OP
120 N 44TH ST STE 100
PHOENIX AZ 85034-1822
jwallace@gseca.org

MICHAEL L KURTZ
BORHM KURTZ & LOWRY
36 E SEVENTH ST STE 2110
CINCINNATI OHIO 45202
Mkurtzlaw@aol.com

GREG PATTERSON
5432 E AVALON
PHOENIX ARIZONA 85018
Gpattersoncpa@aol.com

KEVIN C HIGGINS
ENERGY STRATEGIES LLC
30 MARKET ST STE 200
SALT LAKE CITY UT 84101

ROBERT BALTES
ARIZONA COGENERATION ASSOCIATION
7250 N 16TH STREET SUITE 102
PHOENIX ARIZONA 85020-5270
Bbaltres@bvaeng.com

LAW OFFICES

MARTINEZ & CURTIS, P.C.
2712 NORTH 7TH STREET
PHOENIX, AZ 85006-1090
(602) 248-0372

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DENNIS L DELANEY
K R SALINE & ASSOCIATES
160 N PASADENA SUITE 101
MESA ARIZONA 85201-6764

DAVID BERRY
PO BOX 1064
SCOTTSDALE AZ 85252

THERESA MEAD
AES NEWENERGY
P O BOX 65447
TUCSON ARIZONA 85728
Theresa.mead@aes.com

AZ REPORTING SERVICE INC
2627 N THIRD ST SUITE THREE
PHOENIX ARIZONA 85004-1104

THEODORE ROBERTS
SEMPRA ENERGY RESOURCES
101 ASH STREET HQ 12-B
SAN DIEGO CALIFORNIA 92101-3017
Troberts@sempra.com

LORI GLOVER
STIRLING ENERGY SYSTEMS
2920 E CAMELBACK RD
SUITE 150
PHOENIX ARIZONA 85016
L.glover@stirlingenergy.com

PETER VAN HAREN
CITY OF PHOENIX
ATTN JESSE W SEARS
200 W WASHINGTON SUITE 1300
PHOENIX ARIZONA 85003-1611
Jesse.sears@phoenix.gov

PHILIP KEY
RENEWABLE ENERGY LEADERSHIP
GROUP
10631 E AUTUMN SAGE DRIVE
SCOTTSDALE ARIZONA 85259
Kevtaic@aol.com

WILLIAM P INMAN
DEPT OF REVENUE
1600 W MONROE ROOM 911
PHOENIX ARIZONA 85007
InmanW@revenue.state.az.us

DAVID COUTURE
TEP
4350 E IRVINGTON ROAD
TUCSON ARIZONA 85714

AARON THOMAS
AES NEWENERGY
350 S GRAND AVENUE SUITE 2950
LOS ANGELES CA 90071
Aaron.Thomas@aes.com

PETER W FROST
CONOCO GAS & POWER
MARKETING
600 N DAIRY ASHFORD
CH-1068
HOUSTON TEXAS 77079

RYLE J CARL III
INTERNATL BROTHERHOOD OF
ELEC WORKERS LC #1116
750 S TUCSON BLVD
TUCSON AZ 85716-5698

JEFF SCHLEGEL
SWEEP
1167 SAMALAYUCA DRIVE
TUCSON AZ 85704-3224
Schlegelj@aol.com

ROBERT ANNAN
AZ CLEAN ENERGY INDUSTRIES
ALLIANCE
6605 E EVENING GLOW DRIVE
SCOTTSDALE ARIZONA 85262
Aannan@primenet.com

PAUL BULLIS
OFFICE OF THE ATTORNEY
GENERAL
1275 W WASHINGTON STREET
PHOENIX ARIZONA 85007
Paul.bullis@ag.state.az.us

KELLY BARR
JANA BRANDT
SRP
MAIL STATION PAB211 PO BOX 52025
PHOENIX AZ 85072-2025
Kjbarr@srpnet.com jkbrandt@srpnet.com

RANDALL H WARNER
JONES SKELTON & HOCHULI PLC
2901 N CENTRAL AVE SUITE 800
PHOENIX ARIZONA 85012

MARY-ELLEN KANE
ACAA
2627 NORTH 3RD STREET SUITE TWO
PHOENIX ARIZONA 85004
Mkane@azcaa.org

CURTIS L KEBLER
RELIANT RESOURCES INC
8996 ETIWANDA AVE
RANCHO CUCAMONGA, CA 91739

JAY KAPROSY
PHOENIX CHAMBER OF COMMERCE
201 N CENTRAL AVE 27TH FL
PHOENIX ARIZONA 85073

HOWARD GELLER
SWEEP
2260 BASELINE RD SUITE 200
BOULDER COLORADO 80302
Hgeller@swenergy.org

GARY A DODGE
HATCH JAMES & DODGE
10 WEST BROADWAY SUITE 400
SALT LAKE CITY UTAH 84101

LAURIE WOODALL
OFC OF THE ATTY GEN
15 S 15TH AVENUE
PHOENIX ARIZONA 85007
Laurie.woodall@ag.state.az.us

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19
20
21
22
23
24
25
26

DONNA M BRONSKI
CITY OF SCOTTSDALE
3939 N DRINKWATER BLVD
SCOTTSDALE ARIZONA 85251
Dbronski@ci.scottsdale.az.us

MICHAEL R ENGLEMAN
DICKSTEIN SHAPIRO ET AL
2101 L STREET NW
WASHINGTON DC 20037

DAVID A CRABTREE
DIERDRE A BROWN
TECO POWER SVCS CORP
P O BOX 111
TAMPA FLORIDA 33602
Dacrabtree@tecoenergy.com
Dabrown@tecoenergy.com

MICHAEL A TRENTEL
PATRICK W BURNETT
PANDA ENERGY INTERNATIONAL
4100 SPRING VALLEY SUITE 1010
DALLAS TEXAS 75244
Michaelt@pandaenergy.com
Patb@pandaenergy.com

WILLIAM BAKER
ELECTRICAL DISTRICT NO 6
7310 N 16TH STREET SUITE 320
PHOENIX ARIZONA 85020

JESSE DILLON
PPL SERVICES CORP
2 NORTH NINTH STREET
ALLENTOWN PA 18101-1179
jadillon@pplweb.com

JOHN A LASOTA JR
MILLER LASOTA & PETERS PLC
5225 N CENTRAL AVE SUITE 235
PHOENIX ARIZONA 85012

BRADFORD A BORMAN
PACIFICORP
201 S MAIN SUITE 2000
SALT LAKE CITY UTAH 84140

SAM DEFRAW (ATTN CODE OOI)
RATE INTERVENTION DIVISION
NAVAL FACILITIES ENGINEERING COMMAND
BUILDING 212 4TH FLOOR 901 M STREET SE
WASHINGTON DC 20374-5018

JOAN WALKER-RATLIFF
MANAGER REGULATORY AFFAIRS
CONOCO GAS AND POWER
1000 SOUTH PINE
P O BOX 1267 125-4 ST
PONCA CITY OK 74602
Joan.walker-ratliff@conoco.com

ROBERT J METLI ESQ
CHEIFETZ & IANNITELLI PA
3238 NORTH 16TH STREET
PHOENIX ARIZONA 85016

THOMAS MUMAW ESQ
PINNACLE WEST CAPITAL CORP
POST OFFICE BOX 53999
MAIL STATION 8695
PHOENIX ARIZONA 85072-3999
thomas.Mumaw@pinnaclewest.com


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