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IN THE MATTER OF THE GENERIC PROCEEDINGS CONCERNING ELECTRIC RESTRUCTURING ISSUES	Docket No. E-00000A-02-0051
IN THE MATTER OF ARIZONA PUBLIC SERVICE COMPANY'S REQUEST FOR A VARIANCE OF CERTAIN REQUIREMENTS OF A.A.C. R14-2-1606	Docket No. E-01345A-01-0822
IN THE MATTER OF THE GENERIC PROCEEDING CONCERNING THE ARIZONA INDEPENDENT SCHEDULING ADMINISTRATOR	Docket No. E-00000A-01-0630
IN THE MATTER OF TUCSON ELECTRIC POWER COMPANY'S APPLICATION FOR A VARIANCE OF CERTAIN ELECTRIC COMPETITION RULES COMPLIANCE DATES	Docket No. E-01933A-02-0069 **INITIAL CLOSING BRIEF**

I. INTRODUCTION

Pursuant to the ALJ's order, Arizona Corporation Commission staff ("Staff") hereby files its closing brief in Docket No. E-00000A-02-0051, sometimes referred to as Track B. This proceeding addresses the process that will govern the initial competitive solicitation for wholesale power, which will be conducted by Arizona Public Service Company ("APS") and Tucson Electric Power Company ("TEP") in early 2003.

This hearing was preceded by six and a half days of workshops in which the parties tried to resolve and/or narrow issues. The parties were able to resolve approximately thirteen issues and to agree on a list of seven remaining disputed issues for hearing. In Staff's opinion, the important remaining issues include (1) the determination of APS' and TEP's contestable loads, (2) the timing for Commission evaluations of prudence for any contracts that result from the solicitation, (3) the degree of discretion and authority to be accorded to the utility in its conduct of the solicitation, and (4) the standards of conduct to govern utility/affiliate communications. Less important are the issues surrounding least cost planning, demand side management, and environmental risk mitigation.[1]

Staff's overriding goal is to establish a transparent process that will result in cost savings for ratepayers. (Track B Staff Report – Competitive Solicitation, Ex. S-1 at 1). That is the standard that the Commission should use to evaluate every disputed issue in this proceeding. With two utilities and at least five merchants appearing in this proceeding, all vigorously advocating for their respective positions, it is sometimes possible to forget that this matter is not about protecting the interests of utilities and merchants. (Tr. at 63-64). The major benefit to be realized from a competitive solicitation is cost savings to the ratepayer. (Tr. at 63). If we do not achieve that goal, the solicitation will have failed.

II. WHAT PORTIONS OF APS' AND TEP'S LOADS ARE CONTESTABLE FOR PURPOSES OF THIS INITIAL SOLICITATION?

In establishing amounts of capacity and energy for which APS and TEP should solicit bids, it is important to note that the issue to be addressed is the amount of contestable load, not the amount of unmet needs. Unmet needs describes the capacity and energy that the utility is not able to supply from its own facilities. Contestable load describes the amount of capacity and energy for which a competitive alternative may be available. This proceeding is concerned with determining contestable load amounts, rather than establishing unmet needs.

A. APS - Capacity and Energy in General

For 2003, 2004, 2005, and 2006, APS should solicit bids for 2460, 2734, 2854, and 2950 MW, respectively, of capacity. (Tr. at 52-53; Ex. S-5). In each year, these numbers represent the sum of APS' unmet needs and APS' reliability-must-run ("RMR") capacity. Id. For 2003, 2004, 2005, and 2006, APS should solicit bids for 4,381, 4,963, 8,088, and 8,680 GWH, respectively, of energy. Id. In each year, these numbers represent the sum of APS' unmet needs, APS' RMR energy,

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[1] The seventh remaining disputed issue involved the Staff's "price to beat" concept. Because Staff has withdrawn that proposal, the issue is moot. (Johnson Reb. Test., S-2 at 5-6; Kessler Reb. Test., Ex. S-3 at 4-5).

and economy purchases. Id. These numbers do not include the 215 GWH in 2003 that APS described as a short term hedge. At the hearing, APS witnesses clarified that what they were referring to as a "short term hedge" is in reality a firm contract. (Tr. at 360). Accordingly, Staff agrees that this amount is appropriately excluded from contestable load.

Finally, APS' energy numbers will have to be adjusted because we do not have energy numbers for the Yuma area. (Tr. at 52). Staff anticipates that we will be able to obtain those numbers from the ongoing RMR study. In addition, other numbers in Exhibit S-5 may be impacted by the RMR study; accordingly, Staff recommends that the Commission allow its final numbers to be appropriately updated by the results of the RMR study.

B. TEP - Capacity and Energy in General

For 2003, 2004, 2005, and 2006, TEP should solicit bids for 758, 824, 861, and 898 MW, respectively, of capacity. (Tr. at 53; Ex. S-5). In each year, these numbers represent the difference between TEP's retail load and the transmission import limitations into the Tucson area. Id.

For 2003, 2004, 2005, and 2006, TEP should solicit bids for 493, 734, 716, and 665 GWH, respectively, of energy. These numbers are different than those that appear in S-5, because they incorporate both economy energy and estimates of RMR energy. (Tr. at 57-58).[2] Staff believes that these adjustments are necessary in order to ensure a consistent approach for both APS and TEP. (Tr. at 316-17). In each year, these numbers represent the sum of TEP's unmet needs, TEP's RMR energy, and TEP's economy purchases. (Tr. at 53, 57-58; Ex. S-5). Staff's recommended numbers for TEP exclude the two combustion turbines that are owned by TEP but are not yet in its rate base. (Tr. at 53). It is appropriate to exclude these units because they are not included in TEP's rate base.

Finally, it is likely that TEP's numbers will need to be adjusted as a result of the RMR study. In Exhibit S-5, the local generation number for TEP is missing. Although TEP has provided Staff with estimates for RMR energy since the close of the hearing, these estimates may change as a result of the RMR study. The RMR energy numbers for TEP could potentially be as high as 1,000 GWH annually, which is significant. (Tr. at 171-72, 289-90).

[2] An updated version of Exhibit S-5, which incorporates these figures, is attached as Exhibit A.

C. RMR Capacity and Energy

For both capacity and energy, the utilities will argue that RMR capacity should not be included in the numbers for contestable load. As support, APS will likely cite Decision No. 65154, the Commission's decision in Track A. There, the Commission stated that each utility must "acquire, at a minimum, any required power that cannot be produced from its own existing assets . . . ." Decision No. 65154 at 23 (September 10, 2002). Although APS seeks to use this language as a limitation, it is clear that the Commission's use of the term "at a minimum" was intended to serve as a starting point. In that decision, the Commission also concluded that "the amount of power, the timing, and the form of procurement shall be as determined in the Track B proceeding." Id. By these statements, the Commission did not limit itself from requiring additional amounts to be solicited.

It is reasonable to include the RMR capacity in the utilities' contestable loads. There are conditions under which RMR capacity and energy could be contestable: 1) if non-utility owned or non-rate based generation exists locally, 2) if remote generation has access to non-APS or non-TEP firm transmission capacity that would enable delivery to the local area, and 3) if owners of remote generation offer to finance transmission improvements to remedy the transmission constraint. (Smith Reb. Test., Ex. S-4 at 5). All of these factors are potentially present in these circumstances. As Staff Witness Smith testified at the hearing, we know that there are units internal to the constraint that can bid, we know that there are other transmission paths that could be used besides the incumbents', and we know that, at least in the long term, transmission enhancements could accompany an RMR bid. (Tr. at 147, 149-50, 151,173-74, 279-80). RMR capacity and energy should be bid and managed in accordance with applicable AISA and West Connect protocols.

By including RMR capacity and energy in the initial solicitation, we will find out whether and to what extent the market will provide solutions to transmission import constraints. (Tr. at 173-74, 277-78; Ex. S-4 at 6). Allowing the utility to classify RMR capacity and energy as uncontestable will eliminate this potential benefit of the competitive bid. (Ex. S-4 at 3). It will also encourage the utility to continue to use generation within the constrained area, rather than exploring ways to meet demand with cleaner and cheaper sources. Id.

D. Economy Energy

Staff believes that "unmet needs" should be defined as the difference between a utility's capacity and energy requirements and the amount of capacity and energy that it has available to it at a reasonable cost. (Ex. S-3 at 6). By contrast, APS and TEP appear to believe that "unmet needs" represent the difference between a utility's forecasted load and all the capacity and energy that it is physically capable of generating, regardless of the cost. (Tr. at 184; Ex. S-3 at 7). In the case of APS, this dispute reduces the amount of energy to be solicited by over 3,700 GWH, a significant reduction. (Ex. S-3 at 7, Ex. S-5). APS proposes to cover this amount, which it refers to as its "unplanned needs," by relying on the spot market. (Tr. at 180-181; Ex. S-3 at 7-8).

Staff is not opposed to APS acquiring its unplanned needs in this way as long as APS makes every effort to solicit for all of its unmet needs in a fair and transparent solicitation. (Ex. S-3 at 8). Staff believes that the initial solicitation should include all of the additional capacity the utility believes it will need for the period covered by the solicitation and all of the energy the utility expects to purchase from third parties for the specified time period. Id. at 9. By contrast, APS wants to solicit the capacity it believes that it will need, but then procure short term and economy energy from the spot market. Id. If APS uses this approach, it will forego the opportunity to see if there is energy on the market that is priced in a way to make the spot market unattractive. Id. at 10.

Staff is not suggesting that the Commission require the utilities to purchase all of the energy for which they solicit. (Tr. at 156). The utilities should have the right to reject all bids if the bids do not reasonably meet the needs of the utility and its customers. Indeed, since the utilities will still be expected to supply electricity to their customers in a prudent manner, they will have an obligation to reject uneconomic bids. The utilities should also retain the ability to fill unplanned or unexpected needs from the spot market when appropriate.

Nonetheless, each utility should be required to test the market, i.e., to seek bids for all of the capacity it expects to need in the relevant time period and for all of the energy that it expects to buy from third parties. Only in this way can the utility determine the market prices for both capacity and energy in order to assess the risk of alternative supplies. (Tr. at 181-83; Ex. S-3 at 8-9).

E. Need for Flexibility

Finally, the Commission should not view this proceeding as a search for a "magic" number. Of course, the Commission will have to choose an appropriate number to represent the utilities' contestable loads; however, it would be unwise to require that number to be set in stone. We already know that the figures related to both RMR capacity and RMR energy will have to be updated with the results of the upcoming RMR study. (Tr. at 97, 150; Ex. S-4 at 3-5). In addition, it is reasonable for the utilities to have some flexibility to adjust their contestable load numbers as a result of their needs assessments, which are to be filed as part of the pre-solicitation materials. (Tr. at 91-92, 162-63, 169). In general, the numbers representing contestable load are targets, rather than immutable requirements. (Ex. S-3 at 7).

To summarize, the Commission should focus on determining an appropriate method for calculating contestable load instead of focusing on developing a single "magic" number or group of numbers. Because it will be necessary to update the numbers as a result of the RMR study, the needs assessment, and other subsequent events, any number resulting from this proceeding may be less important than the method used to calculate it.

III. SHOULD THE COMMISSION PRE-APPROVE OR APPROVE ON AN EXPEDITED BASIS THE CONTRACTS RESULTING FROM THIS INITIAL SOLICITATION?

This issue illustrates the inherent conflicts present in the Track B process. The merchants and the utilities contend that a lack of pre-approval will result in bids at higher prices than would be true if pre-approval were granted. However, utilities have historically been able to acquire generation and energy without Commission pre-approval.

Both utilities and merchants argue that pre-approval or expedited approval will promote certainty, thereby protecting the parties to the resulting contracts. (Tr. at 125). Unfortunately, the parties who remain <u>unprotected</u> by this approach will be the utilities' ratepayers, who stand to benefit from a thorough and measured review. (Tr. at 125, 165, 300). The Commission has not required this sort of solicitation before; accordingly, both the Commission and its staff lack experience in evaluating this kind of procurement. (Tr. at 74-75, 110-11). Under these circumstances, it is better to leave the Commission as much flexibility as possible. <u>Id</u>.

The merchants and the utilities have argued that the results of a transparent, fair, and efficient solicitation will be market prices and that these prices will be prudent per se. (Tr. at 77-78). But price is not the only factor that the Commission should consider. Ultimately, the Commission must evaluate whether the utility was prudent in its selection of its portfolio as a whole and whether the utility solicited the right products. (Tr. at 78-79, 107-08). Neither of these factors is addressed by an expedited approval process that assumes the prudence of any contract that results from a competitive bid. (Tr. at 126).

Based upon what we know about the market today, the prices that result from a competitive bid may not be just and reasonable. (Tr. at 117-20, 298-99). There have been occasions where the market has been influenced by inaccurate information. In such a situation, the resulting prices may not be just and reasonable, even though they may be market prices. Id. Concerns of this type have led other states to delay or reformulate their plans for restructuring. (Tr. at 127). And in the Track A order, the Commission expressed concerns over just how workably competitive the relevant wholesale market is. (Tr. at 111-12). In light of these concerns, caution is advisable. (Tr. at 122-23).

Staff believes that there is no reason to change the prudence review process at the same time as the Commission commences a formal competitive procurement process. If the formal competitive process is unable to meet or beat the results that would have occurred under the old monopoly regime, Staff would question the prudence of the utility, as well as whether a truly competitive market exists.

IV. SHOULD THE COMMISSION ALLOW THE UTILITIES TO CONDUCT THE INITIAL SOLICITATION?

Some of the merchants have argued that the conduct of the solicitation and the decision-making associated with it should be shared by the utility, Staff, and the independent monitor. (Tr. at 190-91). Staff, by contrast, recommends that the utility retain the authority to both conduct the solicitation and decide whether to accept bids. (Tr. at 106, 130).

The utility has the obligation to provide reliable service to its customers at a reasonable cost. (Tr. at 188-89). The utility also has the expertise to best determine the products that it needs to fulfill its obligations to its customers. (Tr. at 188-98, 303). As compared to Staff and the independent monitor, the utility is best-positioned to make an informed decision when it evaluates bids. Id. In regulation, the utility usually makes the decisions, and the Commission then reviews those decisions. (Tr. at 190-91). There is no reason in this proceeding to displace that basic premise, as there have not been allegations of impropriety against either of the utilities at this time. Id.

Staff believes that the Commission should leave the obligation to appropriately conduct the solicitation and to select bids with the utility. (Tr. at 192). The oversight provided by the independent monitor as well as Staff participation provide an appropriate level of involvement to ensure that the utilities act in the best interests of customers. In Staff's view, the Commission's ability to hold the utility accountable for its procurement efforts would be unduly compromised by diffusing the decision making authority.

V. WHAT STANDARDS OF CONDUCT SHOULD GOVERN THE SOLICITATION?

Staff recommends that, by January 1, 2003, each utility form a team of employees to conduct the solicitation. (Ex. S-1 at 38). These team members should be segregated from any contact with employees of the affiliate. (Tr. at 141-42; Ex. S-1 at 38). It appears that both APS and TEP have already made efforts to identify and segregate their solicitation team members. (Tr. at 710-11).

Each utility should prepare a draft standard of conduct as part of its pre-solicitation materials. (Ex. S-1 at 38). This draft should be submitted first to Staff and the independent monitor and later to prospective bidders for comment. Id. After the comments have been reviewed, the utility shall make all appropriate changes and publish the final standards of conduct. Id. An acceptable standard of conduct will, at a minimum, include the following: personnel who may be assigned, roles and responsibilities, maintenance of confidential information, communications with affiliated entities or persons, provisions to ensure equal access to information for all persons, provisions to prevent undue advantages, standards for evaluations, protocols for logging communications, records maintenance, procedures for monitoring by Staff and the independent monitor, and procedures for verifying both internal and external compliance. Id.

The standard of conduct is intended to ensure that the utility and its affiliate have procedures in place to provide for separation of information, rather than complete separation of function. (Tr. at

139-40). Staff recognizes that there are shared services between APS and Pinnacle West that cannot realistically be separated or reorganized--at least in time for the first solicitation. Id. Finally, Staff agrees that TEP's wholesale marketing department should not be excluded from TEP's solicitation team in this initial solicitation. (Tr. at 89-90). Because TEP does not have a merchant affiliate, these issues do not present the same degree of risk.

VI. SHOULD THE COMMISSION INCORPORATE LEAST COST PLANNING PRINCIPLES INTO THE INITIAL SOLICITATION?

This issue, which was raised by RUCO during the workshops, was not a significant focus in this proceeding. (Ex. S-1 at 39). Staff believes that least cost planning principles are present in the pre-solicitation process, which requires each utility to prepare load assessments, needs assessments, price forecasts, and various other documents. (See Tr. at 91-92). A responsible utility should use least cost planning principles to develop its overall portfolio.

RUCO, however, seems to want a more formalized approach, one that fosters more Commission involvement in the planning process. Whether this is a good idea, however, is beyond the scope of this proceeding. Whatever the merits of RUCO's suggestions on this issue, they should not be dealt with here.

VII. SHOULD THE COMMISSION INITIATE A PROCEEDING TO ADDRESS DEMAND SIDE MANAGEMENT AND ENVIRONMENTAL RISK MITIGATION?

The Law Fund has requested that the Commission initiate a proceeding to examine how and when DSM and environmental risk mitigation should be factored into the solicitation process. (Ex. S-1 at 39). Given the tight time frame governing the initial solicitation, this issue is simply beyond the scope of this proceeding. Id.

Bidders are, of course, free to submit bids that include DSM or environmental risk mitigation in response to a utility solicitation. Id. Similarly, utilities may solicit renewable resources in the initial solicitation. (Ex. S-3 at 14). These elements should be permitted, but not required, at this time. (Ex. S-1 at 39; Ex. S-3 at 13-14).

VIII. CONCLUSION

Staff recommends the following:

A. The Commission should adopt the methods described by Staff for calculating APS' and TEP's contestable loads.

B. The Commission should refuse to provide for pre-approval or expedited approval for contracts that result from this initial solicitation.

C. The Commission should allow each utility to conduct its solicitation and to determine which bids it will ultimately select.

D. The Commission should direct each utility to form a solicitation team whose members will be governed by appropriate standards of conduct.

E. The Commission should not act on the least cost planning, DSM, and environmental risk mitigation issues at this time.

RESPECTFULLY SUBMITTED this 18th day of December, 2002.

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Nancy Roe

STAFF REVISED CONTESTABLE LOADS ESTIMATE
GENERIC ELECTRIC RESTRUCTURING - TRACK B
DOCKET NO. E-00000A-02-0051, ET AL

CAPACITY (MW)

YEAR	2003	2004	2005	2006
Net Unmet Reliability Needs[1]	1661	1935	2055	2151
APS Phoenix Resources[2]	660	660	660	660
APS Yuma Resources[3]	139	139	139	139
APS	**2460**	**2734**	**2854**	**2950**
TEP Retail Load[4]	1890	1956	1993	2030
-Transmission Import Limit[5]	-1132	-1132	-1132	-1132
TEP	**758**	**824**	**861**	**898**

ENERGY (GWH)

YEAR	2003	2004	2005	2006
Net Unmet Reliability Needs[1]	639	840	1228	1469
APS Phoenix Supplied[2]	37	90	165	263
APS Yuma Supplied	0	0	0	0
Economy Purchase[6]	3705	4033	6695	6948
APS	**4381**	**4963**	**8088**	**8680**
Unmet Needs[7]	50	46	120	104
Local RMR Generation Supplied[8]	183	213	253	276
Economy Purchases[9]	210	429	223	181
TEP	**443**	**688**	**596**	**561**

1 Schedule PME-1, Peter M. Ewen, November 4, 2002 adjusted to include 15% reserves for all load.
2 Work Papers, APS Metro Phoenix Reliability Must Run Estimates, Peter M. Ewen, November 4, 2002, page 76.
3 Schedule PME-9, Peter M. Ewen, November 4, 2002.
4 Exhibit 5, Track B Needs Assessment and Procurement Proposal, David Hutchins, November 4, 2002.
5 Ibid, existing capability with no local generation plus 182 MW for Saguaro to Tortolita 500 kV line #2 in 2003.
6 Schedule PME-13, Peter M. Ewen, November 4, 2002.
7 Exhibit 1, Track B Needs Assessment and Procurement Proposal, David Hutchins, November 4, 2002.
8 TEP Must-Run Summary (12/12) based on Nov. 2 Load Forecast.
9 TEP Purchase Power Summary (12/12) based on Nov. 2 Load Forecast.

EXHIBIT A