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2003 APR 29 P 4: 36

AZ CORP COMMISSION
DOCUMENT CONTROL

8
9 IN THE MATTER OF THE GENERIC
PROCEEDINGS CONCERNING ELECTRIC
10 RESTRUCTURING ISSUES

Docket No. E-00000A-02-0051

11 IN THE MATTER OF ARIZONA PUBLIC
SERVICE COMPANY'S REQUEST FOR A
12 VARIANCE OF CERTAIN REQUIREMENTS OF
A.A.C. R14-2-1606

Docket No. E-01345A-01-0822

13 IN THE MATTER OF THE GENERIC
14 PROCEEDING CONCERNING THE ARIZONA
INDEPENDENT SCHEDULING
15 ADMINISTRATOR

Docket No. E-00000A-01-0630

16 IN THE MATTER OF TUCSON ELECTRIC
POWER COMPANY'S APPLICATION FOR A
17 VARIANCE OF CERTAIN ELECTRIC
18 COMPETITION RULES COMPLIANCE DATES

Docket No. E-01933A-02-0069

**NOTICE OF FILING
ACCION REPORT ON
TRACK B PRE-SOLICITATION**

19
20 Staff hereby provides notice of filing the Accion Report on Track B Pre-Solicitation in Track
21 B of this docket.

22 RESPECTFULLY SUBMITTED this 29th day of April, 2003.

Arizona Corporation Commission

DOCKETED

APR 29 2003

DOCKETED BY	<i>CKE</i>
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1 Original and 19 copies of the foregoing
2 filed this 29^h day of April, 2003 with:

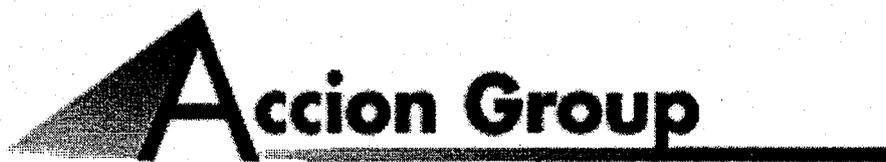
3 Docket Control
4 Arizona Corporation Commission
5 1200 West Washington
6 Phoenix, AZ 85007

7 Copies of the foregoing mailed and/or e-mailed
8 this 30th day of April, 2003 to

9 All parties of record

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Nancy Roe



Arizona Corporation Commission
Utilities Division



INDEPENDENT MONITOR'S REPORT
ON
TRACK B PRE-SOLICITATION

April 22, 2003

**INDEPENDENT MONITOR'S REPORT
ON
TRACK B PRE-SOLICITATION**

I. Introduction

Decision No. 65743 (Decision) of the Arizona Corporation Commission (Commission) established that an Independent Monitor would be appointed for the Track B Solicitations conducted by Arizona Public Service Company (APS) and Tucson Electric Power Company (TEP). The responsibilities of the Independent Monitor include providing a status report after the pre-solicitation process is completed. This report addresses the activities of APS and TEP between January 15, 2003 and April 4, 2003.

During the pre-solicitation period of the Track B solicitation, the groundwork was laid for a successful bidding process. To ensure that all necessary steps were taken, the Independent Monitor worked with the Staff, APS, and TEP to establish:

1. Base line information for each solicitation
2. Solicitation due dates
3. Affiliate standards for APS
4. Bidder qualification standards
5. Schedules for vetting solicitation drafts with Staff & bidders
6. Evaluation processes
7. Communications protocols
8. Monitoring procedures

II. Summary of Status of the Solicitation

The Monitor has observed that the Track B pre-solicitation activities of each utility provided for the production of information necessary for bidders to participate, developed policies and procedures designed to facilitate open and equitable solicitation, and produced RFP materials that will permit fair and open solicitations. Each utility received multiple bids for a variety of products covering both the short term and longer term. Ample capacity was proposed to meet the projected needs of Arizona's consumers and energy merchants have actively participated in this solicitation. Only after pricing data has been analyzed can it be determined whether consumers will benefit from this process. The ultimate success of the solicitation will, however, be controlled by how each utility applies the solicitation protocols and safeguards designed during the pre-solicitation period.

III. Pre-solicitation Process Overview

A. Draft Documents

During the pre-solicitation period, the Independent Monitor frequently conferred with APS, TEP and the ACC Staff. Additionally, the Monitor met with and had frequent communications with virtually all the parties to Track B, including many of the potential bidders. Cumulatively, through these activities the Independent Monitor has been apprised of all pre-solicitation activities and became aware of many of the parties' concerns. During this period the

Independent Monitor made numerous suggestions to each utility, each of which was given full consideration by TEP and APS. Numerous changes to solicitation materials were made in response to those comments as well as to suggestions offered by prospective bidders. In the end, however, the final decisions related to the RFPs issued and all related documents remained the sole responsibility of each utility.

The pre-solicitation process was structured to facilitate a methodical and thorough preparation of solicitation materials. As an initial step, system information needed by bidders was made available to all prospective bidders on web sites created by each utility, and also at bidders' conferences. The materials provided included necessary system, load and transmission information. In addition, each utility used its web site to answer questions from bidders. All questions and responses were published on the web sites and were available to every bidder.

Draft solicitation materials were made available for review and comment by bidders prior to being issued by each utility. Drafts were posted on the web sites in advance of the first bidders' conferences. Revised draft materials were posted periodically for review and comment prior to the release of final bid materials. This process provided ample opportunity for prospective bidders to comment on the materials and to provide suggestions for improving the materials and the solicitation process. Each comment was considered and many were incorporated into the solicitation materials before final documents were released.

It should be noted that, while the draft review process was helpful, it did not eliminate all issues between the utilities and the bidders.

B. Bidder Conferences

As a part of the pre-solicitation process, APS held two bidders' conferences and TEP held one. Each bidder conference provided a forum for open discussion among solicitation participants. This permitted a free exchange of views that all could hear, without the time consuming process of posting questions on the web sites and then waiting for responses. During these open forums, each utility provided bidders with information that assisted bidders in the preparation of bids. If a bidder chose not to attend a bidder conference, all written materials distributed at the bidders conferences were posted on the respective web sites. Neither utility recorded the bidder conferences nor provided written transcription of questions or answers.

APS held two bidder conferences, in large part because their initial draft documents were significantly criticized by most potential bidders. As a result of those criticisms, APS addressed many of the concerns raised by the bidders and made significant changes to its solicitation documents.

TEP held one bidder conference during which bidders and TEP worked together to amend draft documents. Amendments included refinements to the credit support, requested product definitions and the solicitation schedule. As a result of the cooperative atmosphere created by TEP, only one bidder conference was needed to address and resolve bidder concerns.

C. Bidder Certificate

The Decision required bidders to certify they would permit the ACC Staff to inspect generating facilities that would be used to fulfill bid commitments. The Decision required bidders to certify that the ACC has authority to initiate proceedings and to take remedial action in the event a bidder unlawfully manipulates the Western Interconnection wholesale market. TEP and APS required signed commitments from bidders in furtherance of the ACC Decision.

Several potential bidders noted that such a certification might create the potential for a conflict between the ACC and FERC and questioned the ACC's authority to regulate wholesale electric generators. Several potential bidders refused to execute the required Bidder Certificate prepared by TEP and APS.

APS' and TEP's forms were drafted to reflect the language in the Decision. Several bidders ultimately chose not to bid, in part because of concerns they claimed to have regarding this issue. Several others have not yet executed the Certificate. These concerns were raised shortly before the solicitation was released, which provided insufficient time for resolution of this issue before bids were due. At the urging of the Independent Monitor, APS and TEP agreed to consider bids without an executed Bidder Certificate, with the understanding this matter would be resolved before pricing data and standard products bids are provided by bidders on April 23rd and 24th.

D. Regulatory Out Clause

As originally drafted, APS' RFP incorporated a proposed contract term that would have allowed APS the unilateral right to immediately terminate any contract entered as a result of this Track B solicitation, if any governmental body made any finding or adopted any rule, regulation or law, that adversely affected APS' ability to recover the costs APS incurred pursuant to those contracts. Several potential bidders expressed reservations regarding APS' proposed regulatory-out clause and advised the Monitor that such a clause might prevent them from bidding due to the uncertainty it created. After extensive discussions with the Monitor, APS agreed to modify that term to allow for bilateral rights to terminate deliveries of capacity and energy after 1/1/06, if the ACC does not approve those contracts within 12 months of APS filing for such approval. APS committed to make such filings within 2 months of the completion of the current solicitation. APS also advised bidders that it would consider bids that struck the regulatory-out clause but further advised bidders that that clause was deemed to be a critical term in the evaluation process and ranking of bids.

While the Monitor appreciates the business reasons for including such a term in contracts for long-term power supplies, we are concerned that the clause as drafted could (1) inhibit bidders from proposing long-term offers and (2) might expose ratepayers to additional risks and uncertainty in later years by providing sellers a right to withdraw from favorably priced contracts if the ACC chooses not to act on APS' filings for approval of the contracts it executes. APS was required to carefully balance the risks to both its customers and to its shareholders. The

decision was clearly not an easy one to make. APS exercised reasonable judgment in this area by limiting the risks to all parties to those years after 2005 only, and by assuring itself and all bidders ample time to replace or resell capacity and energy if any contracts are terminated pursuant to the clause.

While several bidders advised the Independent Monitor that they would not bid long-term offers as a result of the inclusion of a regulatory-out clause, several long-term offers were received and are being evaluated at this time.

TEP did not incorporate a regulatory-out clause in its proposed form of contract and we are unaware of any bidder who has proposed one.

E. Web Sites

Both APS and TEP established dedicated web sites for this solicitation.

The APS site is secured and all bidders were required to establish passwords for access. The web sites are used to distribute documents and to provide the primary means of communications between the bid solicitation teams and potential bidders. Both companies use the web sites to answer questions and to provide those answers to all bidders concurrently. Only credit-related questions and answers specific to a bidder are not posted on the web site.

Although APS was slow to get its web site established and its procedures for establishing access were needlessly cumbersome and often ineffective, the site operates effectively and is maintained and updated in a timely fashion. The TEP site has worked well since it was established. Each site provides a valuable benefit to the process.

F. Bid Fees

The Decision authorized each company to assess a bid fee of up to \$10,000 per bidder to offset the cost of conducting the solicitation. Both TEP and APS chose to assess the full amount on each bidder. While several potential bidders complained that the fee was not standard in the industry, only two bidders refused to pay the fee. Those offers have now been rejected and the respective bids will not be evaluated. Several bidders did not include the bid fee with their initial submission. Both TEP and APS allowed all bidders in that position an opportunity to cure that defect and all, except for the bidders discussed above, have now paid the required fee.

While not "standard" in the industry, bid fees are not uncommon and did not impair the ability of bidders to participate in this solicitation.

G. Bid Process

Each company adopted a unique approach to receiving bid information from bidders, tailored to its proposed evaluation process.

TEP bifurcated the submission of bids by product type, requiring the submission of bids for non-standard products on April 4th and the submission of bids for standard products on April 23rd. TEP's evaluation process appears to be consistent with its normal system planning practices and is fairly straightforward.

APS' bid process required all bidders to submit bids on April 4th. Bids for non-standard products had to include pricing information, while bidders for standard fixed-price products will supply pricing information on April 24th. Once

prices are added on April 24th, the fixed-price bids will remain open until April 28th but bidders may withdraw their bids by 5:00 p.m. on April 25th. This structure was a compromise adopted by APS after bidders complained that they could not hold fixed price bids open for the entire period between April 24th and April 28th. In order to enhance the ability of bidders to "stay in the game," APS also is accepting fixed price bids tied to an index thereby allowing APS to lock-in a fixed price at any time between April 24th and April 28th. This process was adopted to accommodate APS' ability to model and evaluate submitted bids, while meeting the requirement that all bids be evaluated concurrently.

During the period between April 4th and the submission of pricing information, both companies will be in contact with bidders to ascertain additional data and to clarify any ambiguities that exist in the submitted bids. These communications will be conducted only through emails and cover operational questions as well as credit-related issues. Thereafter, the companies may engage in direct negotiations with selected bidders to finalize contracts. The Independent Monitor will monitor all negotiations, either in person or telephonically.

TEP intends to complete its contracting by April 25th. APS intends to short-list bidders by April 28th and to start executing contracts anytime between then and May 22nd, with all contracts finalized by May 22, 2003.

Each company has designed a reasonable approach to managing the collection of bids and data to enable them to concurrently evaluate all bids. The process and timing encourages bidder participation. The Monitor is unaware of

any part of the pre-solicitation that created an unfair advantage or disadvantage for any bidder.

H. Delivery Points

TEP and APS delineated various delivery points on their systems as "preferred," but indicated a willingness to consider offers of delivery at alternative points. Bidders have taken advantage of that flexibility and have bid delivery of products to a variety of delivery points. Both companies are evaluating their ability to, and the economic value of, accepting products at each proposed delivery point.

During APS' second bidders' conference, it distributed information "ranking" its preferred delivery points. The ranking created some confusion among the bidders and with the ACC Staff. Bidders were concerned that the ranking would influence the evaluation, even if there was no economic or operational impact associated with the potential delivery to the alternate points. Staff was unclear on how APS would use the ranking and had questions regarding how the rankings were established.

APS has assured the Monitor that the rankings would not be used to evaluate bids unless a clear operational or economic impact could be demonstrated. According to APS, the information provided at the second bidders' conference was intended to provide bidders with a better understanding of APS' import capability. Staff has also advised the Monitor that its concerns were resolved.

To date, no bids have been rejected by either APS or TEP because a proposed delivery point was unacceptable.

I. Environmental Information

The Decision required that APS and TEP consider the environmental impacts of the contracts they execute, and that all bidders submit environmental data regarding the sources of capacity and energy they propose to supply. Bidders were instructed to provide summaries of environmental information. Winning bidders will be required to provide more extensive information.

Bids received by both companies have all included certain emissions and other data as required by the Decision. To the extent that additional data is needed, the companies will query the bidders.

Neither company is using the environmental data in evaluating the economic value of any bid, or in determining the operational appropriateness of any bid. How APS or TEP will address the ACC concerns relative to environmental matters has not, to the knowledge of the Monitor, been decided.

J. Blind Bidding

The Decision encouraged the utilities to use "blind bidding," that is, evaluation of bids without identification of the bidder, to the extent practicable. However, because APS and TEP solicited bids for a variety of products, including both standard and non-standard products, a blind bidding structure proved to be too cumbersome. This issue was irrelevant in the TEP solicitation because all

bidders were arms-length participants. Because APS' affiliate, PWEC, submitted a bid, the issue had to be addressed in that solicitation.

In conducting the evaluations each utility must have access to certain information. Some of this information is specific to the source of energy and capacity being bid, making it difficult to mask the identity of the bidder. Each utility must also evaluate the credit-worthiness of each bidder before accepting any offer. Such information is, by definition, bidder-specific and providing it would disclose the identity of bidders. Additionally, proposed contract amendments weigh heavily in the evaluation process and must ultimately be matched to operational and economic criteria to complete the process. Blinding the bids, therefore, was rejected as unworkable in this solicitation. The Independent Monitor and APS explored a variety of ways of creating a blind, or even partially blind, bidding process. Each proved impractical for various reasons. Examples of blind bidding approaches considered by the Independent Monitor and APS included:

1. Removal from each bid of all references to a bidder and generating plant. This was rejected because so many bid components would indicate the bidder's identity.

2. Having the Independent Monitor extract key bid information and then provide APS with a matrix of all bids without the identity of bidders. For example, quantity, term, delivery point, products, could be extracted. This approach presented many significant challenges making it impractical. The most significant problem was bids for unique products would be difficult to disguise.

Also, core information (product, quantity, term, etc.) would need to be matched with bidder-specific credit information in short order, making this approach useful for only a limited period.

3. Accepting blind bids for fixed, standard products (such as, 6x16 energy for summer 2003) and evaluating other products after the standard product needs were met. This was rejected as being in conflict with the Decision requirement that all Track B bids be evaluated concurrently.

APS and the Independent Monitor considered a number of variations of these approaches without identifying an appropriate blind bidding method. The major barriers to the Track B solicitation being conducted as a blind bid were the need for a concurrent evaluation of bids and the potential liability of APS or the Monitor if bid information was omitted, erroneously redacted, or inaccurately transcribed.

Absent an ability to fashion a workable blind bid process, APS and the Independent Monitor focused on the goal of preventing any PWEC bid from receiving a preference. To address this it was agreed that the Monitor would hold the unopened PWEC bid until all other bids were evaluated. PWEC data was then evaluated using the same tools and assumptions as all other bids. When pricing information is received, PWEC's pricing will be held until all other pricing information is analyzed and a preliminary ranking of bids is prepared and delivered to the Monitor. If required, a revised ranking will be prepared to reflect the evaluation of the PWEC prices and a "short list" of acceptable bids will be prepared.

While not a perfect solution, this approach will allow APS to conduct its evaluation in a reasonable manner and not provide PWEC any opportunity, or the appearance of any opportunity, to price or structure its bids based on information submitted by other bidders.

K. Review Process

APS and TEP are using similar review processes. The differences reflect the need to limit APS' access to PWEC bid information for a significant period.

THE APS PROCESS:

1. On Friday, April 4, 2003, all bids were received by APS. Bidders were sent emails confirming receipt by the 5:00 p.m. submission deadline. At 6:00 p.m., the Independent Monitor opened each bid, except the bid from PWEC. The only persons present were the Independent Monitor, a member of the ACC Staff, and a delegate from the Pinnacle West Treasurer who attended to receive the checks for bid fees. The Monitor logged in all bids and the materials provided in the opened bids.

2. At approximately 7:30 p.m. on April 4, 2003, the Independent Monitor delivered all opened bids to the APS bid solicitation team. That team reviewed each bid and notified bidders by email of any missing or incomplete documents or bid requirements that same evening. Rather than reject an incomplete bid, bidders were given until noon on Monday, April 7, 2003, to cure defects.

3. The Independent Monitor retained possession of the submission by PWEC, in its original, sealed package until APS advised the Monitor that it completed its non-price evaluation of all offer bids on April 16th.

4. Between April 4, 2003, and April 24, 2003, APS will evaluate and rank bids for all non-price criteria.

5. On April 24, 2003, bidders will provide prices for standard product and other fixed-price bids submitted on April 4, 2003. Bidders may withdraw their bid before close of business on Friday, April 25, 2003. APS will provide the Independent Monitor with all prices. The Independent Monitor will verify that only prices received by 5:00 p.m. MST on April 24, 2003 are evaluated. After that, all fixed price bids are firm until April 28th and others until May 22nd.

6. By Monday, April 28th, APS will prepare a short-list of bids it wishes to accept.

7. Concurrently, on Monday, April 28, 2003, APS will begin negotiations with bidders on credit terms, contract provisions, and other bid terms. The Independent Monitor will monitor all negotiations, either in person or telephonically.

While the approach in use is not a blind bidding process, it limits the likelihood of the APS evaluation being crafted to favor PWEC. Therefore, we accepted this approach as a reasonable substitute for a blind bidding process.

THE TEP PROCESS:

TEP has no affiliate bidding in the Track B solicitation. Accordingly, the safeguards constructed for the TEP solicitation are not as stringent. TEP is, however, using a process similar to the APS process.

1. On Friday, April 4, 2003, all bids were received and bidders were sent emails confirming receipt of their bids. Starting at 5:30 pm, TEP personnel opened the bids. The Independent Monitor and a member of the ACC Staff were present, but no bidders were present.
2. On April 24, 2003, bidders will provide prices for consideration by TEP, thus completing their bids.
3. Like APS, TEP will evaluate bids once completed with prices. The bids will be ranked and negotiations with individual bidders regarding contract terms and the specifics of bids will be conducted. The Independent Monitor will monitor all negotiations, either in person or telephonically.
4. TEP will notify winning bidders on April 25, 2003.

It should be noted that both TEP and APS instituted a series of "cure" opportunities for bidders, even though this was a step not included in the solicitation process adopted by the Decision, and was not discussed during the Track B workshops. The "cure" process afforded bidders the opportunity to provide missing information or documents after the date for the submission of bids.

We believe this additional step was both appropriate and a demonstration that TEP and APS are willing to demonstrate flexibility in order to keep a wide array of

bids available for evaluation. While this had the effect of providing some additional time to a few bidders, it did not disadvantage other bidders because the opportunity to cure was provided to all incomplete bids, and because the period for cure was within a few days of the initial submission date and well before evaluation of bids was completed.

L. Credit Requirements

Credit requirements were, and remain, the areas of greatest concern for bidders and utilities alike. The volatility of the energy market and the potential exposure in the event of default combine to make this a critical element of the evaluation process.

APS initially required significant credit assurances from all bidders, but was unwilling to provide any credit assurances to potential bidders. In response to this position, a number of bidders claimed that they would not participate in the solicitation unless appropriate credit assurances were provided by APS. Ultimately, the company agreed to extend bilateral credit to bidders with better credit ratings than APS. APS has claimed that it lacks the financial capacity to provide credit assurances to support all the capacity and energy purchases it may make as a result of this solicitation. The inability of APS to provide bilateral credit assurances to all bidders, especially all investment grade bidders, may impact the prices APS is offered and may limit the number of bidders willing to contract with APS. A number of bidders indicated they would attempt to address the APS credit restrictions through contract terms. Review of the terms of any

contracts entered into by APS and bidders, along with how credit terms are negotiated during the solicitation process, will likely determine whether the APS restrictions adversely affected the solicitation. This area will continue to receive close monitoring.

TEP is in a different situation than APS, both because its credit rating is not investment grade and because the volumes likely to be acquired through the solicitation would create less exposure in the event of default. Even with these considerations, TEP proved to be far more amenable to working with bidders to fashion credit requirements that encouraged participation. TEP provided bilateral credit assurances for all bidders with credit ratings equal to or greater than TEP's. The company also expressed a willingness to consider alternative forms of credit assurance based on the bid and the terms offered by a bidder. While the TEP solicitation will be monitored to assure that credit assurance is not used as a barrier to evaluation of bids, we do not anticipate a problem to occur with that utility.

M. Standards of Conduct

During the pre-solicitation phase of this Track B process, APS was required to establish protocols to assure the ACC and potential bidders that the evaluation of bids would be conducted in an equitable and auditable fashion. In order to accomplish this, APS set up a team of personnel who would conduct the process and would refrain from any communication with any other Pinnacle West personnel, including and especially, personnel from PWEC, on any matter

relating to this solicitation. Concurrently, PWEC also established a team to prepare any bid it chose to submit to APS. APS also prepared a written set of Standards of Conduct for this solicitation, which were reviewed by the Monitor and by the ACC Staff. APS provided training with regard to those Standards of Conduct to the APS team, the PWEC team, and to other APS personnel notably those "shared services" personnel who might directly or indirectly assist either team.

These efforts were generally successful but several notable situations arose that required intervention by the Monitor.

In establishing its team, PWEC proposed assigning an officer of PWEC to its team who also held an executive position at APS. This arrangement provided the PWEC bid team with operating knowledge and data relative to the APS system that was not available to other bidders. The Monitor advised PWEC that the assignment presented a potential conflict and a clear appearance of conflict and should be rectified. Initially, PWEC failed to resolve the problem and the Monitor advised APS that if the situation was not corrected, we would advise the Commission of our concerns and would ask to have PWEC's bids disqualified. PWEC subsequently removed that officer from its bid team prior to the date on which bids were due.

More difficult to resolve was the potential for conflict created by Pinnacle West's corporate structure and its use of shared services. Although fairly common in today's utility industry, APS' shared services structure is still in the process of development. Today, the Pinnacle West structure does not provide

complete separation of its regulated and unregulated business units. This is problematic because of the need to avoid even the appearance that PWEC will have an unfair advantage in the Track B solicitation.

The specific problem, in this case, is that both APS and PWEC will require Risk Management authorizations to both buy and sell capacity and energy. Corporate risk tolerance is determined by Pinnacle West Capital's board of directors and dictates each business unit's risk level. Today at Pinnacle West, individual units do not have set risk limits. Therefore, in order to accept bids, APS requires advice provided by the APS risk management group, which also provides that service to all other Pinnacle West units, including PWEC.

PWEC also requires risk management advice in order to prepare its bids. The advice would also come from APS' risk management group. However, virtually every member of the APS risk management group has directly or indirectly assisted the APS bid team and may, therefore, be ineligible to provide PWEC with assistance pursuant to the APS Standards of Conduct.

In order to allow PWEC to participate, it was agreed that PWEC would independently prepare its risk assessment as required by Pinnacle West's Board and could consult with Pinnacle West's CFO who has ultimate responsibility for corporate risk management but has had and will have no direct contact with the APS team.

While not optimal, this solution is both reasonable and equitable. It allows PWEC to participate, which may benefit ratepayers, and provides no undue advantage to PWEC.

We are continuing to monitor this situation closely.

CONCLUSION

The Pre-Solicitation Process has been completed and the Independent Monitor found that it is appropriate to move to the next phase of the Solicitation.

Dated: April 22, 2003

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