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FROM: Ernest G. Johnson
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E-00000A-02-0051
E-01345A-01-0822
E-00000A-01-0630
E-01933A-02-0069

DATE: May 30, 2003

RE: STAFF REPORT FOR THE GENERIC PROCEEDING CONCERNING THE ARIZONA INDEPENDENT SCHEDULING ADMINISTRATOR (DOCKET NO. E-00000A-01-0630)

Attached is the Staff Report for the generic proceeding concerning the Arizona Independent Scheduling Administrator.

EGJ:RTW:lhm

Originator: Ray T. Williamson

Attachment: Original and Thirteen Copies

Arizona Corporation Commission
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Docket No. E-00000A-01-0630

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STAFF REPORT
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GENERIC PROCEEDING CONCERNING THE ARIZONA INDEPENDENT SCHEDULING ADMINISTRATOR

DOCKET NO. E-00000A-01-0630

MAY 2003

STAFF ACKNOWLEDGMENT

The Staff Report for the generic proceeding concerning the Arizona Independent Scheduling Administrator (Docket No. E-00000A-01-0630) was the responsibility of the Staff member listed below.

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Utilities Engineer

EXECUTIVE SUMMARY
ARIZONA INDEPENDENT SCHEDULING ADMINISTRATOR
DOCKET NO. E-00000A-01-0630

In the Track B Decision (Decision No. 65743, issued on March 14, 2003), the Commission required that Staff update its November 2001 AISA Staff Report, consider the Commission's recent decisions and make recommendations in the generic AISA docket.

Prior to answering the question about the need for the AISA, Staff believes that a much more fundamental question needs to be asked and answered. That question is:

> Does the Commission want to have retail electric competition available to customers in Arizona over the next two to five years?

Staff believes that there are numerous options that the Commission could consider in relation to the continuation or closure of the AISA. The following four options could be considered by the Commission:

Option 1: End the retail electric competition effort in Arizona, close down the AISA and return to a traditional regulated monopoly structure.

Option 2: Retain the existing Retail Electric Competition Rules and close down the AISA.

Option 3: Retain the existing Retail Electric Competition Rules and downsize AISA.

Option 4: Combine the consideration of the AISA with the Commission requirement in the Track A Decision that Staff open a rulemaking to review the Retail Electric Competition Rules. The downsized AISA would remain in place while the review is undertaken.

Staff recommends that the Commission select Option 4 as the best alternative.

TABLE OF CONTENTS

BACKGROUND

As part of the development of Arizona's Retail Electric Competition Rules, it was determined that, in order to have non-discriminatory retail access, Arizona should establish an independent scheduling administrator until such time as a Regional Transmission Organization was in place. This requirement was included in Section 1609 of the Competition Rules.

In 1999, steps were taken to establish the Arizona Independent Scheduling Administrator ("AISA"). The AISA continues to be in existence today.

The service territories of APS and TEP were opened to competition in 1999 and a modest amount of competitive service was available in Arizona in the 1999-2001 timeframe. However, all competitors withdrew from offering competitive electricity service in Arizona by the middle of 2001.

In 2001, the Commission established a new docket, "Generic Proceeding Concerning the Arizona Independent Scheduling Administrator" (Docket No. E-00000A-01-0630). In this docket, a number of questions regarding the continued viability of AISA were asked and stakeholders were asked to respond to the questions.

In November 2001, Staff filed a Staff Report that summarized the stakeholder comments and responses to the questions. In addition, the Staff Report included a Staff Legal Analysis, a Staff Analysis, and Staff Recommendations.

On January 22, 2002, the Commission approved a generic docket on electric restructuring (Docket No. E-00000A-02-0051). In February 2002, the generic docket was consolidated with a number of other related dockets. Eventually, the effort was bifurcated into Track A and Track B.

The Track A decision (Decision No. 65154) was issued on September 10, 2002. The Track B decision (Decision No. 65743) was issued on March 14, 2003.

Included in the Track B decision was a requirement that Staff update its November 2001 Staff Report and consider the Commission's recent decisions and make recommendations in the generic AISA docket.

THE MISSION OF THE AISA

The original intent in forming the AISA was to provide a temporary organization that would perform certain functions until such time as an Independent System Operator, or as they are now known, a Regional Transmission Organization was in place. The responsibilities of the AISA were described in the Retail Electric Competition Rules (R14-2-1609 D). The AISA was to:

- Implement and oversee the nondiscriminatory application of operating protocols to ensure fair and equitable transmission access.
- Provide a dispute resolution process to resolve any claims of discriminatory treatment in the reservation, scheduling, use and curtailment of transmission services.

- Calculate Available Transmission Capacity ("ATC") for the Arizona transmission providing utilities and other AISA participants and develop and operate a statewide Open Access Same Time Information System ("OASIS").

- Utilize a single standardized procedure for all requests (wholesale, Standard Offer retail, and competitive retail) for reservation and scheduling the use of the Arizona transmission facilities belonging to the Affected Utilities and other AISA participants.

- Implement a transmission planning process to assure that future load requirements will be met.

The Retail Electric Competition Rules (R14-2-1609.E) also require that the Affected Utilities that own or operate Arizona transmission facilities shall file an AISA implementation plan that addresses:

- AISA governance, incorporation, financing and staffing.

- Acquisition of physical facilities and staff by the AISA.

- Schedule for the phased development of the AISA functionality and proposed transition to a regional Independent System Operator ("ISO") or Regional Transmission Organization ("RTO").

- Contingency plans to ensure that critical functionality is in place no later than three months following the adoption of the Retail Electric Competition Rules by the Commission.

- Any other significant issues related to the timely and successful implementation of the AISA.

The AISA Board of Directors determined that the implementation of the AISA Protocols Manual should be in a phased approach. Stage 1 of Phase I began upon the acceptance and approval by the Federal Energy Regulatory Commission ("FERC") of the AISA tariff filing. Stage 2 of Phase I will become effective upon Board determination that more staff is needed to move from a limited Protocols Manual oversight to a more active administration which would include the monitoring by the AISA of compliance with FERC's standards of conduct related to access to transmission and the operation of the transmission system. The Phase II functions will be implemented after action by the AISA Board of Directors.

Phase I, Stage 1 Functions

The Transmission Providers ("TP") and Control Area Operators ("CAO") will implement the AISA protocols, except those specifically granted waivers.

The AISA will implement:

- Alternative Dispute Resolution ("ADR") and limited Protocol Manual oversight,
- Monitoring of OASIS and Allocated Retail Network Transmission ("ARNT").

Phase I, Stage 2 Functions

Fully administer Protocols Manual functions with the exception of Phase II functions.

Phase II Functions

- Monitoring of ATC releases and responsibility for OASIS/ATC calculations,
- Utilization of standardized procedures for transmission reservation and scheduling,
- Implementing a statewide transmission planning process,
- Administering a statewide OASIS,
- Overseeing Transmission Provider determinations of total retail Committed Use reservations; and
- ARNT and Energy Imbalance ("EI") trading and ARNT auction settlement

CURRENT STATUS OF AISA

At the April 25, 2003 Board Meeting of AISA, the Board of Directors voted to downsize the operations of the AISA. The downsizing included the reduction of 1.25 full time employees, a reduction in office space, and reductions in insurance and accounting costs. This action resulted in a 54% reduction in the annual AISA budget from $332,650 to $154,270.

The downsizing will take place effective June 1, 2003. It will include the reduction of one full-time employee position and the reduction of the Acting Executive Secretary position from a full-time position to that of a ¾ time position.

At the May 14, 2003 Board Meeting of AISA, the Board of Directors took action to modify Article I of the AISA Articles of Incorporation to remove a sunset clause which previously indicated that the corporation would cease to exist on September 15, 2003. The new wording, approved by the Board of Directors, states that "The Corporation shall exist until a Federal Energy Regulatory Commission approved Regional Transmission Organization is operational serving Arizona."

KEY ISSUE DECISION

Prior to answering the question about the need for the AISA, Staff believes that a much more fundamental question needs to be asked and answered. That question is:

> Does the Commission want to allow retail electric competition as a consumer choice to customers in Arizona over the next two to five years?

Until this question is decided, the issue of whether there should be an AISA can not be fully decided. If the Commission wishes to reconsider the usefulness of the ASIA, the question should be asked again. Staff suggests that if the answer is "no", the retail electric competition rules should either be abolished, or, if retail competition is to be postponed, the rules should be suspended until needed. If competition is delayed, there is no immediate need for the AISA and it could be closed down. However, there would be a substantial cost in the future to establish a new organization to perform similar functions as the AISA. According to AISA sources, it cost over $1.4 million to establish the AISA, develop and receive FERC approval of the AISA Protocols Manual.

Staff suggests that if the answer to the question is "yes", then Arizona will need the AISA or some substitute organization to perform the functions that were originally intended to be performed by an ISA. Although some would argue that the new Regional Transmission Organization would fulfill these functions, the establishment and operation of that new RTO (West Connect) would probably not occur until 2007 or 2008.

CHANGES SINCE THE NOVEMBER 2001 STAFF REPORT

Although it was hoped in 2001 that the Arizona Independent System Operator called DesertSTAR would become operational in the 2003/2004 time frame, progress toward establishing DesertSTAR stalled.

In DesertSTAR's place, Arizona stakeholders proposed to establish WestConnect as a Regional Transmission Organization. The development of WestConnect is progressing, but at a very slow pace.

Over 10,000 MW of new generation capacity has either commenced operation, commenced construction, or been approved for construction in Arizona. These new plants, in addition to the 1,830 MW that came on line in 2001, will offer a large pool of resources for competitors in the retail electricity market.

In the past few months, both Arizona Public Service Company ("APS") and Tucson Electric Power Company ("TEP") have issued competitive wholesale solicitations, as required by the Track B decision. Now that the results of those solicitations are known, the new wholesale plants which were not winners in the solicitation will be anxious to find customers for their idle or unused generation capacity. If these plants are able to offer low cost electricity contracts to Electric Service Providers in Arizona, there could be a new wave of retail electric competition in the state.

IMPACTS OF THE TRACK A AND TRACK B DECISIONS

What has changed as a result of Track A and Track B decisions?

The Track A and Track B decisions primarily address enhanced wholesale competition. However, by enhancing wholesale competition, the two decisions set the stage for potential renewed interest in retail electric competition. In fact, now that the winners and losers have been identified in the current Arizona competitive wholesale solicitations, there will be significant amounts of new generation capacity searching for customers. If the price they offer is low enough, it could encourage a resurgence of interest in retail competition in Arizona. Because there is a limited amount of transmission capacity which connects to other states, many of the new power plants would need to sell their electricity in Arizona.

TRIGGERING EVENTS FOR RENEWED INTEREST IN RETAIL ELECTRICITY COMPETITION

There are a number of "triggering events" that could spur an increased interest in retail electricity competition in Arizona:

- **Competitive wholesale power producers offering extremely low electricity price contracts to "hungry" Electric Service Providers in Arizona**. Now that APS' and TEP's initial wholesale competitive solicitations have produced contract winners, those not selected will have plenty of electricity to offer for sale. Since there is limited transmission capacity available to other states, the market conditions in Arizona will be ideal for ESPs to obtain low-cost electricity contracts.

- **The rates for APS will change in 2004 as a result of the rate case filed in 2003.** The reduction in electricity rates for APS customers over the past few years has acted as a deterrent for customers to switch to competitive suppliers. If the rates approved for APS in 2004 increase and if the competitive "shopping credit" increases, the APS customers may suddenly find that competitive suppliers can offer savings, resulting in a renewed interest in retail competition in the APS service territory.

- **TEP is required to file a report with the Commission by June 1, 2004, on the need for modifications to the Fixed or Floating Competitive Transition Charge**

("CTC"), TEP's distribution tariffs, and other unbundled components. Any changes to TEP's rates would be implemented no later than January 1, 2005.

- **FERC rules on Standard Market Design will probably be finalized in 2003.** It is too soon to say what, if any, impacts the SMD rules will have on retail competition in Arizona and the nation.

- **Potential new ESPs emerging in Arizona.** New Electric Service Providers could choose to select Arizona as a new market for their products. Arizona is one of only a limited number of states that currently offer retail access for electricity customers.

- **Completion of Arizona's review of its Retail Electric Competition Rules.** One reason the ESPs may not have chosen to come to Arizona is that this state, like many other states, has chosen to review its rules and procedures for competition. Potential competitive ESPs will likely "sit on the sidelines" until that review process is over before committing the time and significant resources that it will take to enter the Arizona market.

OPTIONS

Staff believes that there are numerous options that the Commission could consider in relation to the continuation or closure of the AISA. The following four options could be considered by the Commission:

Option 1: End the retail electric competition effort in Arizona, close down the AISA and return to a traditional regulated monopoly structure.

Option 2: Retain the existing Retail Electric Competition Rules and close down the AISA.

Option 3: Retain the existing Retail Electric Competition Rules and the downsized AISA.

Option 4: Combine the consideration of the AISA with the Commission requirement in the Track A Decision that Staff open a rulemaking to review Retail Electric Competition Rules. This could include a review of <u>all</u> aspects of competition in Arizona and would specifically invite participation by potential national competitors that may be interested in becoming Electric Service Providers in Arizona. The review would include a full discussion of the role of AISA in Arizona's marketplace, to include an evaluation of the AISA structure, functions, and organization. The downsized AISA would remain in place while the review is undertaken.

STAFF COMMENTS ON OPTIONS

General Comments

As previously mentioned in the November 2001 Staff Report, there still remain two basic viewpoints concerning the AISA:

- Organizations in favor of retail electricity competition and which potentially can profit from the competition. These organizations insist that the AISA, or some similar organization is necessary for viable retail electric competition.

- Organizations that will be adversely impacted by competition. These organizations say that AISA is not needed.

There really have been no major changes in these positions since the Retail Electric competition rules were adopted.

Although some would claim that the new Regional Transmission Organization, WestConnect, can fulfill the functions that are reserved for the AISA, such is not the case. First of all, it is doubtful that WestConnect will be operational any time soon and may not actually commence operation until 2007 or 2008. In fact, recent presentations by WestConnect officials indicate that WestConnect will probably not be fully operational until 2011.

Second, the focus of RTOs and WestConnect, in particular, will be on wholesale transactions, not on the provision of retail service, though scheduling of energy transactions for direct access retail customers has to be planned by Scheduling Administrators on the transmission systems under the RTO's jurisdictional control. It is uncertain whether FERC will allow its approved Regional Transmission Organizations, such as WestConnect, to perform the retail functions that are included in the AISA Protocols Manual.

Staff Comments on Option 1 (End Retail Competition Rules/Close AISA):

The choice of this option is determined by the answer to the question: "Should there be retail electricity competition in Arizona?" Staff believes that the Commission has already answered this question in the Track A and Track B decisions. However, the question could always be revisited. If the answer is no, the Commission could choose to abolish, amend, or stay the Retail Electric Competition Rules. The stay would be an appropriate option if the Commission chooses to institute retail competition at a later date.

However, one of the pitfalls of this option is that it would result in the abandonment of the Reliability Must Run Protocols and the associated retail transmission rights established as part of the AISA implementation effort. These retail transmission provisions are critical for preserving Arizona's native load transmission service via constrained transmission paths. FERC has approved these provisions even though it argues against native load rights in other venues.

Staff Comments on Option 2 (Retain Retail Competition Rules/Close AISA):

Since there is no current retail competition, it could be argued that the AISA should be closed as it is not needed at the current time. Staff is concerned that if the AISA is closed, this action will provide another barrier to Arizona's attempt to attract competitive Electric Service Providers. Staff believes that the AISA is a necessary but not sufficient condition needed to encourage retail competition in Arizona. If we close down the AISA, we could lose potential competitors that we do not even know are considering entering our market. Staff also believes that there may be some other, more fundamental changes to Arizona's retail competition effort that could reinvigorate Arizona's competitive marketplace. It would be a shame if we discovered those changes after we had already closed the AISA. Also, the new Standard Market Design rules, expected to be issued by FERC by the end of 2003, could have a significant impact on retail competition in Arizona. We do not know what kind of an impact that will be.

One of the pitfalls of this option, as in Option 1, is that it would result in the abandonment of the Reliability Must Run Protocols and the associated retail transmission rights established as part of the AISA implementation effort.

Staff Comments on Option 3 (Retain Retail Competition Rules and Downsized AISA):

This really is a status quo approach. The competition rules would continue unchanged and the downsized AISA organization would continue. Although this is a viable alternative while we await renewed interest in retail competition, the downsized AISA (with only one part-time staff person) might find it difficult to expand its services if the renewed interest in retail competition came quickly. The primary efforts of the part-time staff member would be on dispute resolution, limited protocols oversight, and monitoring of the OASIS and ARNT.

Staff Comments on Option 4 (Consider AISA as part of Electric Competition Rules review):

Staff believes that the decision of whether to continue the AISA or close it down should not be made without full consideration of how the decision might affect future retail electric competition in Arizona. A number of parties participated in the Track A and Track B processes. With the possible exception of one competitor, APS Energy Services, there was no participation by the Electric Service Providers who are absolutely necessary if Arizona wants to have any robust retail electric competition in the future. Somehow, we need to search out and request participation by national retail electricity competitors in the process to gauge their level of concern about having an independent organization that will ensure their fair and equitable access to the transmission system.

Now that the AISA Board of Directors has approved a major reduction of the AISA budget to a "bare minimum" level of operation, Staff believes that this option is preferable. The Staff-led Retail Electric Competition Rules review can consider any appropriate changes to the Rules, while, at the same time, consider how the AISA will fit in Arizona's future competitive market and how the AISA structure, functions, or organization could be changed to enhance Arizona's future competitive market. Keeping AISA at this bare minimum level would allow Arizona to be prepared to respond quickly if renewed retail competition were to commence in the state.

STAFF RECOMMENDATIONS

Staff Recommendation:

1. The Commission should approve Option 4:

   - Combine the consideration of the AISA with the Commission requirement in the Track A Decision that Staff open a rulemaking to review Retail Electric Competition Rules. This could include a review of all aspects of competition in Arizona and would specifically invite participation by potential national competitors that may be interested in becoming Electric Service Providers in Arizona. The review would include a full discussion of the role of AISA in Arizona's marketplace, to include an evaluation of the AISA structure, functions, and organization. The downsized AISA would remain in place while the review is undertaken.

Staff recommends that the Commission select Option 4 as the best alternative. This option serves as insurance for the possibility that interest in retail competition can be renewed. Electric Service Providers will want to know that they will have fair access to the Arizona transmission system.

They will want to know that if problems do arise in procuring transmission service that they will have an independent organization upon which they can rely for dispute resolution. The only other alternative would be to take the dispute to FERC, which can be an expensive and time consuming process. In particular, the time delays of such a process can make or break the success of these new competitors. If an ESP were to expend substantial funds to acquire new customers, but then be unable to deliver the promised electricity, it could damage the company and ruin its reputation. The key in dispute resolution is impartiality and prompt resolution at a minimum expense. For relatively small ESPs working on thin profit margins, the option of having FERC resolve disputes over transmission is not an economically viable alternative.