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May 16, 2007

Docket control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

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2007 MAY 16 P 4:44
AZ CORP COMMISSION
DOCKET CONTROL

RE: Arizona Public Service Company's Initial Comments
Competitive Procurement Workshop
DOCKET NO. E-00000E-05-0431

Dear Madam or Sir:

Arizona Public Service Company is providing the attached comments in response to a request for written comments that emerged from discussions at the April 25, 2007 Competitive Procurement Workshop. APS appreciates the opportunity to work with Staff and the interested parties to address both resource planning and competitive procurement issues, and looks forward to on-going participation in these workshops.

If you have any questions or wish to discuss these matters further, please call me at 602-250-4563.

Sincerely,

Barbara Klemstine

Attachment

BK/scc

Arizona Corporation Commission
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Arizona Public Service Company
Initial Comments – Competitive Procurement Workshop
Docket No. E-00000E-05-0431
May 16, 2007

Introduction

On April 25, 2007, the Arizona Corporation Commission (“Commission”) held the first of a planned series of workshops on resource planning. That workshop, in which representatives of Arizona Public Service Company (“APS” or “Company”) participated, addressed procurement issues. At the conclusion of the workshop, Staff requested that interested parties file comments and positions related to competitive procurement practices. This document is APS’s response to that request. The Company first provides an overview of its position and then addresses specific questions raised.

Overview of the Company’s Position

Arizona is now the fastest growing state in the United States and APS serves one of the fastest growing service territories in the country. It is therefore critical that Arizona utilities, the Commission, and other interested parties work together to ensure that the necessary infrastructure and resources are available to meet the state’s dramatic growth and demand for electricity. The preeminent focus of these workshops, as well as resource planning and procurement in general, should be to enable Arizona load serving entities to ensure resource adequacy, manage risk and deliver reliable electricity at a reasonable cost.

The Company’s resource plan evaluates and identifies the resources best suited to meet the Company’s obligation to serve at a specific point in time. The decisions and methods associated with the procurement of power and/or physical resources represent the ultimate implementation of such a resource plan, taking into account the dynamic and rapidly changing conditions in regional and global markets that impact the cost and availability of energy resources within Arizona. Consistent with the requirements set forth in Decision No. 67744, and its Commission-approved Code of Conduct, the Company uses a flexible approach to procurement to meet its obligation to serve by procuring the most economic and reliable resources in as timely a manner as possible. It is essential that the Company retain flexibility with respect to both its planning and procurement activities in order to allow it to ensure resource adequacy, manage risk and deliver reliable electricity at a reasonable cost to Arizona customers.

Essential Components for Fair and Effective Competitive Procurement

Basically, there are two approaches to power procurement. First, power can be procured from the wholesale energy market through contracts with third parties, *i.e.*, purchase power contracts (“PPAs”). PPAs may be acquired from various entities in the market ranging from banks, energy traders, other utilities and independent power producers. Second, power may be procured through the acquisition or construction of

physical generation resources. Suppliers in the market for physical generation resources include engineering firms, contractors, equipment providers, investment funds and developers. This is a global market which is extremely dynamic and is sensitive to the many factors affecting global demand and supply that occur within and beyond the Western region and Arizona. Effective competitive procurement procedures must allow load-serving entities to efficiently and effectively utilize both methods and explore all market options in order to acquire adequate, reliable resources at reasonable cost. This requires sufficient flexibility in timing, procurement methods, and resource options. Utilities need the flexibility to engage these parties in an optimal manner for its customers' benefit.

The Commission has approved a process for APS to address these issues, pursuant to its Code of Conduct, which incorporates the Company's Secondary Procurement Protocol, (approved in Decision No. 68741) and provisions of the Settlement Agreement that were adopted with modifications by Decision No. 67744 (April 7, 2005). Decision No. 67744 allows the Company to test the "market" to determine whether the wholesale energy market can provide adequate and the most economic power for APS customers. If the wholesale energy market cannot do so, the Company has the ability and obligation to seek Commission authorization to acquire and own generation resources. If APS were to consider an affiliate proposal, the protocol for communications is established. The combination of Decision No. 67744 and APS's Code of Conduct provides credible, effective procurement guidelines that must be considered in the discussion of procurement rules for APS and other utilities.

APS believes that consistency in requirements will benefit all of the interested parties. It also is important to understand, however, that Arizona utilities are buying from a market that is geographically small with respect to short-term procurement, but is regional, national and even global for long-term resource acquisition. It is a simple fact that Arizona utilities collectively, much less a single utility like APS, do not have any ability to control or even strongly influence the market for long-term power. Arizona utilities should have consistent procedures that provide fair access to the different markets, and those procedures should not put Arizona utilities at a disadvantage as compared to other regional utilities. Any procurement procedures developed through the workshops should be focused on and limited to the procurement of mid-to-long term resources.

All Market Participants Need to be Considered

It also is important that any procurement procedures developed allow the utilities to procure resources from all market segments, understanding that market participants play different roles over time. Utilities must be able to engage all participants to get the best resources for customers. The market participants that need to be considered include:

- Marketers (i.e., banks and larger asset owners) – These entities buy and sell liquid products, predominantly in well established short-term and intermediate-term markets;

- Developers – These entities typically retain and oversee a group of contractors to package turn-key generation at the request of entities (including load serving entities or merchant plant owners) interested in owning generation. Developers may be large entities, but more often are small limited liability companies;
- Merchant Generation – These entities typically construct “speculative” generation with the intent of selling the output of the plant to the market. True merchant generation implicitly involves taking speculative positions on wholesale power prices. While there was a surge of merchant generation development 5-10 years ago, there currently is no new merchant generation being developed in Arizona, due to the risk and the inability to get long-term financing;
- Engineering, Procurement and Construction (“EPC”) Contractors – These entities, much like developers, contract with a purchaser for the construction of new generation resources to be owned by load serving entities and merchant generators; and
- Bankers/Investors – These entities finance new or existing generation assets when those assets can demonstrate an adequate revenue stream.

For a utility to be able to engage the different market participants, it must be able to contract for PPAs of different lengths and structures, purchase existing generation facilities, or contract for the construction and acquisition of specific new facilities. Procedures that restrict utilities to requests for proposals (“RFPs”) and PPAs are harmful to the utility’s customers. All stakeholders benefit when a procurement process is competitive, consistent, fair and open to all market segments.

Formalizing Procedures

The Commission has structured the workshops in the coming months to address Resource Planning, of which competitive procurement is but one component. Determining whether there is any need for additional formalized procedures prior to finalizing the framework for resource planning and its relationship to power procurement would appear to be premature and, possibly, counterproductive.

A review of resource planning and procurement in other states provides some perspective. Nevada has established a robust resource planning process that provides for open discussion on resource options, clarity on resource preferences, and a defined action plan. With the emphasis on risk management and portfolio management, less weight is put on the procurement process or wholesale electric markets. It appears that Nevada’s process will achieve its goal of managing risk to provide adequate resources at a reasonable cost. Due to its rapid growth, nature of its load and desert climate conditions, Nevada is perhaps the state most similar to Arizona. In addition, similar to APS,

Nevada's primary utility, Sierra Pacific Resources, does not have a competitive affiliate engaged in the business of building and owning merchant power plants.

California, on the other hand, is trying to tackle all aspects of planning and procurement, ranging from long-term reliability requirements to short-term nodal pricing. Although the result in California is detailed rules and procedures, those rules and procedures are extremely burdensome and disjointed, and provide no certainty of satisfactory results. The highly prescriptive and procedural requirements in California has lead to procurement efforts that span many months or, in some cases, years, before a final decision is implemented. For obvious reasons Arizona should avoid emulating the California approach. While other states have different rules, there is no one that is perfect or necessarily fits Arizona. The goal of the workshops should be to define the state's objectives for resource planning and procurement and determine the protocol to follow that appropriately engages the Commission, utilities and other necessary parties.

Responses to Specific Procurement Issues Raised

The following provides initial comments of APS on the issues identified in Staff's minutes from the April 25, 2007 workshop. Additional input will be provided throughout the workshop process and in presentations as APS develops a better understanding of each issue.

- 1) *Should the Commission go through a formal rulemaking to formalize procurement procedures?*

Procurement procedures do not require formal rulemaking. As discussed above, the Company manages its procurement pursuant to Commission Decision No. 67744 (Settlement Agreement) and Decision No. 68741 (Code of Conduct). The Company believes that its current procedures are adequate and that no new formalized procurement procedures are necessary. Areas that warrant further consideration include the need for timeliness and regulatory certainty in the procurement process. If the Commission should consider imposing prescriptive requirements related to procurement, then the Company believes that a formalized rulemaking would be necessary to allow all entities to fully participate and understand the effects of the regulatory mandates.

- 2) *What types of generation, purchase power, or fuel resources should be subject to formalized procurement procedures?*

The procurement workshops and any subsequent procedures could address all energy-related resources. However, APS and other utilities have been procuring generation, purchase power and fuel resources for decades, utilizing well established, effective and efficient processes.

- 3) Should an Independent Evaluator be required as part of the process, and if so, what is the appropriate role for the Independent Evaluator?

APS does not believe that an Independent Evaluator ("IE") would be useful or beneficial to a cost effective competitive power procurement process where a utility affiliate is not participating as a potential seller. That position is supported by most jurisdictions in the Western Electric Coordinating Council ("WECC"), including Washington, Nevada, New Mexico, Idaho, Montana and Wyoming.

If the Commission determines that IEs are desirable, the role that the IE will play needs to be clearly defined up front and the following standards should apply to the process. First, IEs should be assigned only at the request of a third party participating in the RFP. Second, the cost of the IE should be borne by the requesting party(ies). Third, Commission Staff should contract with the IE, who would work under their direction. Fourth, the IE's role should be to evaluate each utility's procurement process. The IE should not perform or review economic, financial, or risk analysis supporting the selection of resource alternatives (although Staff always has the prerogative to separately employ one or more consultants to assist it with such an effort if desired). Fifth, the IE should be required to strictly evaluate the process pursuant to the express standards mandated by the Commission. And, sixth, the IE's approval of the process should be conclusive and preclude future challenges, evidentiary hearings or contested prudence concerns on those matters considered by the IE in performing its role.

- 4) Should there be any required protocols for a utility self- build or affiliate bid and build situation?

APS agrees that if an affiliate bids and builds resources for a utility, then protocols are appropriate. As discussed above, APS already has such protocols in place. As for the "self-build" option, APS believes that no protocols are necessary.

It is important to first clarify that for APS, "self-build" means ownership, as defined by Decision No. 67744. From a practical perspective, it is a project constructed by a *non-affiliated third party* on behalf of the utility. APS is not in the business of constructing power plants and would rely on the market to provide that service. Furthermore, APS only acquires such resources for the purposes of meeting its obligation to serve. It does not have an affiliate that builds generation, as is the case with certain California utilities, and the Company does not benefit financially by choosing one market builder over another.

In the case of APS, the role of internal engineering and procurement personnel within the Company is to evaluate, negotiate, and enter into and oversee

activities under such contracts on behalf of its customers. This role is essentially the same whether the utility enters into a project management agreement with an EPC contractor, or enters into an arrangement with a third party developer which will, in turn, enter into an EPC contract. APS's internal engineering and procurement staff must ensure that any proposed physical resource that would be added to its portfolio will meet all of the operational, reliability, safety, environmental and efficiency requirements necessary for the Company to assume ownership.

- 5) Should the Commission have a direct role in the procurement process (i.e., should the Commission approve draft RFPs, the timing of any required Commission proceedings, and cost recovery and prudence issues for utilities)?

No. Involving the Commission in the review and approval in the RFPs and other procurement processes would be time intensive, and would require dedicated Commission resources, particularly because of the need for timely responses to the market. APS believes that the procurement process is best dealt with by the Company, for which the procurement and provision of energy is the basis of its business. Commission should be on board with resource needs and procurement practices. To the extent the Commission mandates a prescriptive process, both fundamental fairness and administrative efficiency dictate that compliance with that process should carry with it an assurance of cost recovery and some presumptions regarding prudence.

- 6) The design, mechanism and timing of the RFP, including evaluation criteria to be used.

APS believes the utility needs the flexibility to tailor the RFP to meet the specific need requirement. The timing of any solicitation will be dictated by the resource need and the evaluation criteria will be based on a life-cycle cost analysis and the associated risk factors for a given resource.

- 7) The interaction of a formalized procurement process with a utility subject to a building moratorium.

Because APS is the only utility that is currently limited regarding self-build options, APS believes it is important to clarify that the Company is not subject to an absolute preclusion from acquiring or owning new generation. Instead, in Decision No. 67744, the Commission required APS to first test the competitive wholesale market to determine whether it can provide adequate, economic resources to meet customers' needs. If the market cannot provide these resources, Decision No. 67744 made it clear that the Company was required to seek Commission approval to acquire and own the necessary generation resource and specified the factors that the Company was required to address in any application for asset ownership. APS will continue to meet

that requirement, but the requirement needs to be managed so that it does not impair APS's ability to obtain timely and cost effective resources. That can be accomplished through a combination of expedited review and consistent rules. Regardless, the fundamental principles for a procurement process should be the same regardless whether a utility is subject to such requirements or not.

8) Protocols for the process of evaluating RFPs that ensure integrity of the process.

APS believes that the workshops should focus on developing a process that is fair, open and transparent, and that shows no bias toward any stakeholder or group. APS agrees that a critical element of a procurement process is that an RFP be conducted with integrity and that protocols can provide some assurance that the utility is conducting its RFPs consistently and in a manner that is fair to the market. To the extent that protocols are established for evaluating RFPs, it will be critical that such review be completed in a timely manner.

9) How should confidential and trade secret information provided by bidders be handled?

The need to protect confidential and trade secret information exists for both bidders and the utilities. APS believes that its RFP process ensures to the extent possible the protection of a bidder's confidential information, as that information can be shared with others only under limited and specified circumstances (e.g., in response to a Commission request under a protective agreement).

APS recommends that information be put into three general categories: public, Confidential Information, and Competitively Sensitive Confidential Information. Each category of information must be treated appropriately and APS agrees that it would be valuable for all parties to have an understanding of how those terms are defined.

APS believes that the definition for Confidential Information included in Protective Agreements used by the Commission Staff is appropriate. Such Confidential Information should be shared only with parties who have executed an appropriate Protective Agreement with the disclosing party. Competitively Sensitive Confidential Information is a subset of Confidential Information and consists of information that would put the providing party at a competitive disadvantage, as well as non-public information on generation or transmission outages/availability. Such information should be shared with a very limited number of people (e.g., limited outside counsel and consultants) who would not be able to gain an advantage as a result of access to such information.

A fair and open process does *not* mean that all participants should be allowed to see all of the information. To do so clearly would put the utility, and its customers, at a significant competitive disadvantage. For example, bidders should not be allowed to see bids submitted by other entities. Neither should bidders be allowed to see the details of the assumptions used by the utility to determine the anticipated life-cycle cost of the bids. APS believes that a fair and open competitive procurement process would include the following elements:

- All interested parties should be made of aware of the utility's resource needs and be given information on how resource allocation decisions are made.
- Bidders should be provided information regarding how the utility makes its resources selections, including factors evaluated and cost modeling used, but should not be allowed to see the specific assumptions utilized by the utility to complete its analysis.
- Bidders should not be allowed to see bids from other parties or utility Competitively Sensitive Confidential Information that the utility must protect to ensure that it obtains the best resources for its customers.
- Commission Staff should be able to see all information developed for or during the procurement process, provided that Confidential Information and Competitively Sensitive Confidential Information are covered by a Protective Agreement.

10) *To what extent should there be bid fees or other prequalification requirements for bidders?*

Bid fees serve two primary purposes. First, they provide an incentive to ensure that only entities that are serious about submitting a bid will respond to an RFP. Second, they assist in providing cost recovery for the time and resources it takes the utility to conduct the procurement process. The use of a bid fee is common for RFPs, and APS has been conscientious about keeping its bids fees on the low side of what typically is seen in the market. As discussed in response to Question No. 3, the cost of an IE should be recovered from requesting party(ies) and/or through the bid fees.

Although there will be some variation between RFPs, bidders also should be required to meet certain prequalification requirements such as financial viability, ability to deliver the resource to the requesting utility, and operational and development experience.

11) How should non-conforming bids be treated?

The utility should clearly identify the minimum threshold requirements in the RFP and each proposal that meets those requirements should be evaluated by the utility. If a proposal does not meet the requirements, the utility should be able to reject the proposal.

12) How should bids that are submitted outside of an RFP process be treated?

Generally speaking, a utility should not entertain alternative proposals for like products or technologies *during an active formal solicitation*. However, the Company should be able to procure resources through other forms of competitive solicitation, as well as through bilateral negotiations.

13) How should DSM and renewable proposals be handled and what evaluation criteria should apply for each to ensure that the value of each is fairly reflected?

The resource planning process defines how alternative technologies fit into the overall portfolio and how they will be evaluated. The same essential criteria should apply to all resources and consistency in the evaluation approach is essential. Both quantitative and qualitative factors should be analyzed to determine the most attractive resource for a given solicitation. It is important to realize that not all resources provide the same benefits and costs, and these differences need to be captured in the evaluation process.

14) Should the procurement process be tailored to interact with a utility's integrated resource plan and should the Commission begin to require the filing of such plans?

A utility's resource plan establishes the resources that the utility needs to acquire. The procurement process is a means to acquire those resources. The procurement process needs to be flexible enough to allow the utility to adapt to changes in the market and industry by adjusting both the resources it procures and how it accomplishes that procurement.

With respect to whether the Commission should begin to require the filing of resource plans, APS believes that issue will be addressed through the separate resource planning workshops that have been scheduled. APS will be addressing this issue, as well as other resource planning issues, in comments submitted in that workshop.

- 15) Should the utility be required to adopt a Code of Conduct and/or Best Practices?

APS already has in place a Code of Conduct that was approved by the Commission in Decision No. 68741 (June 5, 2006).

- 16) What waivers or exceptions to this process should be adopted?

Consistent with general Commission practice, if a party believes an exception or waiver is necessary because of its circumstances, a party always should have the right to seek such an exception or waiver, with a timely determination of its request.