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October 12, 2007

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

RE: Arizona Public Service Company's Initial Comments
Competitive Procurement Draft Staff Report
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 on the Draft Staff Report that was filed in Docket Control on October 2, 2007.

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

Sincerely,

Barbara Klemstine

Attachment

BK/dst

Cc: Ernest Johnson
Barbara Keene
Parties of Record

Arizona Corporation Commission
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OCT 12 2007

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**Arizona Public Service Company
Response to Staff's Draft Report
Competitive Procurement Workshop
Docket No. E-00000E-05-0431
October 12, 2007**

Arizona Public Service Company ("APS" or "Company") has appreciated the opportunity to participate in the three Competitive Procurement workshops ("CPP Workshops") under the leadership of the Arizona Corporation Commission Staff. The Company has previously filed comments¹ in response to Staff's requests in this docket. The following comments are in response to the Draft Staff Report on Competitive Procurement Issues for the Generic Investigation into Electric Resource Planning ("Draft Staff Report"), which was issued October 2, 2007.

Introduction

The Company concurs with the fundamental concepts addressed in the Staff Report. Most importantly, because Arizona is a state with dynamic growth, it is critical that there be the necessary infrastructure and resources available to meet the state's increasing demand for electricity. Arizona's load serving entities must be able to ensure resource adequacy, manage risk, and deliver reliable electricity at a reasonable cost. It is essential to develop a procurement process that is fair, open and transparent and that shows no bias toward any stakeholder or group.

The Company agrees with Staff that it is premature to conduct a rulemaking on procurement issues at this time, primarily because power procurement is an integral part of the Integrated Resource Planning ("IRP") process. The IRP workshops that the Commission is currently conducting are the appropriate forum to develop the overall regulatory approach regarding long-term resource planning and procurement. The IRP process and any associated rules should, of course, supersede and replace such informal guidelines as are suggested in the Draft Staff Report and the Staff's Recommended Best Practices for Procurement ("Best Practices").

In regard to competitive procurement practices, APS is in a unique position, as compared to other jurisdictional utilities, because the Commission has already approved a process for APS to address competitive procurement. The Commission addressed procurement practices in the Company's Code of Conduct, which incorporates the Company's Secondary Procurement Protocol (approved in Decision No. 68741), and in the provisions of the Settlement Agreement that were adopted with modifications by Decision No. 67744 (April 7, 2005). Decision No. 67744 requires the Company to test the wholesale energy market to determine whether the 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 and the use of an independent monitor are established in its Code of Conduct. These Commission decisions were issued after an evidentiary hearing, where the issues were fully examined, and APS must comply with their mandates. That being

¹ APS docketed its Initial Comments on May 16, 2007, and its Second Set of Comments on July 23, 2007.

said, and although the Company believes that a rulemaking is the desired approach for formal procedures, under the circumstances and given the current status of the IRP workshops, the Best Practices is a potentially useful interim vehicle for providing further guidance for all parties, until such time as the Commission adopts IRP rules.

Proposed Modifications and Clarifications

Overall, the Best Practices address the concerns and reflects the discussion of the participants in the CPP Workshops. Generally, the Company believes that Commission guidance on an interim basis can provide some certainty in the procurement process. However, there are some areas of the Best Practices that require clarification or modification. For example, based on the discussions at the CPP Workshops, the focus of Best Practices protocols are on the procurement of supply-side power. To avoid confusion, the Best Practices should provide an exception that clarifies that the requirements for Request for Proposals (“RFPs”) do not apply to other components of energy procurement, such as transmission projects, fuels and fuel transportation.² The Company has incorporated its recommendations into a redline version of the Best Practices, which is attached as Attachment A.

Short-Term Acquisitions

Staff has recommended that utilities should first “look to the market” for procurement options and that a RFP process should be the primary means by which utilities acquire needed wholesale power. Nonetheless, Staff did recognize that there may be exceptions to the RFP approach. The Best Practices describes a “planning horizon” of two years or less as one such exception, as well as an exception for short-term acquisitions to maintain system reliability. The Company believes that these two exceptions should be condensed into a single exception for short-term acquisitions that involve contract terms of less than five years. Five years is the accepted dividing line between short and long-term acquisitions of power pursuant to Decision No. 67744. For short-term acquisitions, an RFP takes longer, is more complex and is generally not the best practice acquisition procedure, as compared to the use of electronic trading platforms, energy brokers, and other forms of bilateral procurement practices.

Currently, the Company utilizes well-established policies and procedures for energy acquisitions of less than five years. APS does not use bid solicitations or RFPs to buy this energy because of the liquid nature of the market centers where it buys electricity. APS’s energy traders generally select offers through an online third party trading system or via direct telephone contacts. APS continually optimizes the value of its energy portfolio by examining and responding to changing prices and available opportunities. Using RFPs to acquire energy products with terms of less than five years would not be the best practice because RFPs would be less efficient than the existing methods and it would reduce the flexibility the Company needs to obtain resources at the optimal prices. Furthermore, the Settlement Agreement that was adopted by the Commission in Decision No. 67744 recognized these practical considerations, as it defined long-term

² APS does not interpret the Best Practices as encompassing transactions such as gas hedges or other fuel procurement activities.

resources as five years or longer.³ Proposed language to incorporate this modification is set forth in Attachment A.

Resources Requiring Long Lead Times

While the Company agrees with Staff that the RFP process is a valuable tool by which utilities can acquire needed wholesale power information and resources, RFPs are not “best practice” for procurement of all resources. Staff recognized this by excluding short-term purchases, which generally involve standard products and standard terms from existing generating plants. The Best Practices should also recognize that for those resources that require long lead times, such as new base load facilities, bilateral negotiations may be the preferred approach.

For this type of resource, RFPs or Requests for Information may be used to test the market for indicative pricing, preliminary technology options, and the availability of comparable existing resources. However, such a project typically requires a substantial amount of engineering, expense, and contract negotiations with multiple parties. Final cost will depend upon a number of variables during the siting, engineering, contracting, and permitting activities requisite to committing to such a project. For these reasons, a RFP process will generally not be an adequate vehicle for securing such resources. In addition, and for these same reasons, an RFP for such a project may result in a limited number of potential serious bidders. Therefore, in order to pursue the least cost options, it is important that the Company have the flexibility to also secure such resources through bilateral negotiations. This point was discussed during the CPP Workshops and supported by the utilities, as well as individuals representing companies that construct new facilities. Therefore, the Company asserts that the Best Practices should address these circumstances and provide that in the event a utility should pursue a long-term proposal outside of an RFP, it will provide written notice to Staff. Proposed language to incorporate this modification is set forth in Attachment A.

Exceptions for Renewable and Demand Side Resources

The APS Code of Conduct specifies that the competitive procurement principles do not apply “to transactions to satisfy APS’ obligations under Commission’s Environmental Portfolio Standard, proposed Renewable Energy Standard and Tariff [“RES Rules”], and Demand Side Management programs.”⁴ In contrast, the Best Practices contain a more narrow exception in that it requires RFPs as the primary acquisition process for everything except purchases from distributed renewable energy resources.⁵ APS believes that the broader exception that is within its Code of Conduct should be encompassed in any Best Practices adopted by the Commission. The recently enacted RES Rules has its own procurement requirements, where the utility is required to file a description of its procedures for choosing Eligible Renewable Energy Resources and a certification from an independent auditor that those procedures are fair and unbiased and have been appropriately applied.⁶ Having multiple procedures that apply to the procurement of the same resources adds unnecessary complexity and confusion. Demand Side Management programs, which would also include demand response programs, do not involve power

³ See, Decision No. 67744, Attachment A, paragraph 78(a).

⁴ Decision No. 68741, Exhibit A (“APS Code”), at 11, Part Four, section I (B).

⁵ Draft Staff Report, Appendix 1, *Procurement Methods*, section (2)(E) (issued October 2, 2007).

⁶ A.A.C. R14-2-1812(B)(6).

procurement. These are customer programs that facilitate the management of the utility's load and should not be restricted to a competitive procurement RFP process. Proposed language to incorporate this modification is set forth in Attachment A.

Utility Benchmark

As the Commission indicated in its Track B Decision, the goal of competitive solicitation is to provide customers with reliable power at the lowest cost, while encouraging the development of a vibrant wholesale generation market in the state.⁷ In this docket, Staff has indicated that the lowest cost option is the appropriate procurement selection.⁸ In order to assess the least cost option, a utility must develop its own planning estimate or "benchmark price" when seeking resources in the market, so that it will have a measuring stick upon which to compare the reasonableness of bids. This planning estimate was the subject of much discussion at the CPP Workshops.

The Best Practices address this issue by requiring that one week prior to the issuance of the RFP, the utility must provide the Independent Monitor with a copy of the bid proposal prepared by the utility or its affiliate, or any benchmark or reference cost the utility has developed against which to evaluate the bids. APS recommends that the utility bid or benchmark cost be provided to the Independent Monitor one week prior to the deadline for submitting bids, rather than issuance of the RFP. The costs of labor and equipment can change significantly in a short period of time, so having the utility numbers provided as close to the same time that bids come in is important for an accurate comparison to be made for purposes of selecting the least cost option. This change will increase the relevance of the utility numbers, and ensure comparability between resource options.

Secondly, the Best Practices should provide clarification regarding the utility's ability to evaluate bids. Pursuant to the Best Practices, the utility will provide the Independent Monitor with a copy of its benchmark cost or bid proposal in advance of the receipt of any bids from the market, and the Independent Monitor will secure that information in a location where it is not accessible to any of the bidders, the utility or its affiliate. Once the utility's benchmark cost or bid proposal is submitted to the Independent Monitor, then those utility personnel responsible for developing the benchmark cost or bid proposal should be free to assist other utility personnel in the evaluation of the bids. This approach ensures that the utility will take an unbiased approach, and most importantly, that the most knowledgeable people are evaluating the RFP bids, so that the utility's customers will get the best proposal. Staff supported this position in the Commission's Track B proceeding, where Staff acknowledged that the utility has the expertise to best determine the products that it needs to fulfill its obligations to its customers to provide reliable service at reasonable cost, and that as compared to Staff and the Independent Monitor, the utility is best-positioned to make an informed decision when it evaluates bids.⁹

Proposed language to incorporate these modifications is set forth in Attachment A.

⁷ Decision No. 65743 (March 14, 2003) at 16.

⁸ See, Draft Staff Report at 7, discussing the role and benefits of an Independent Monitor.

⁹ Decision No. 65743 (March 14, 2003) at 54.

Recovery of the Cost of an Independent Monitor

Staff has specified that the utilities should be allowed to recover the cost of the Independent Monitor. The Company believes that recovery of those costs through bidders' fees would be most appropriate, but it should be noted that these costs could significantly increase the amount of these fees. Depending upon the extent of an RFP, the scope of the work as dictated by the procedures suggested, and the final procurement procedures, the expense of an Independent Monitor could exceed the total of bidders' fees the Company has typically received. Another option is that the utility could require the winning bidder to pay all or a significant portion of the cost of the Independent Monitor. To the extent that any of the Independent Monitor's costs have not been recovered by bidders' fees, the Best Practices should include language to allow the Company to defer those costs for recovery in a future regulatory proceeding. Proposed language to incorporate this modification is set forth in Attachment A.

Selection of an Independent Monitor

The Company believes that the Best Practices provide a good deal of constructive guidance regarding the engagement of an Independent Monitor. A point that needs further clarification is how an Independent Monitor is finally selected if an interested party makes an objection to the Independent Monitor initially selected by the utility. The Best Practices allow interested parties 30 days to object to the selection of an Independent Monitor. After that, the process for resolving such a disagreement is unclear. Would Staff then be required to provide a written response to the objection? How much time would the Staff have to respond? Would the resolution of such a disagreement require a Commission decision at an open meeting? This uncertainty in the process would more than likely delay and/or impede the RFP process for an unknown period of time.

To address these concerns, the Company is proposing the following procedure for the selection of an Independent Monitor. Under the Company's modified proposal, the utility, in consultation with Staff, would develop a "vendor list" of three to five companies or consultants who are capable of serving as an independent monitor. The utility would provide the list to Staff and file it in the docket for interested parties' review. Interested parties would be permitted to comment/object within 30 days of filing. With or without objection from interested parties, Staff would endorse the vendors it found appropriate within 60 days of the utility's filing. Once the list of authorized vendors is endorsed by Staff, the utility would be able to retain any of the authorized vendors as an independent monitor for its future RFPs. The utility would be required to provide written notice to Staff of its retention of the Independent Monitor. Proposed language to incorporate these modifications is set forth in Attachment A.

Conclusion

APS currently has specific Commission mandates regarding its procurement processes pursuant to its Code of Conduct, the provisions of Decision No. 67744, and the Settlement Agreement adopted in that decision. The Company urges Staff to make the modifications and clarifications discussed above, to assure that the final Best Practices are a practical, effective and efficient tool for competitive procurement solicitations and consistent with the existing mandates affecting APS.

APPENDIX 1

**RECOMMENDED BEST PRACTICES
FOR PROCUREMENT**

Procurement Methods

1. The following procurement methods are considered to be acceptable for the wholesale acquisition of energy, capacity, and physical power hedge transactions:
 - A. Purchases through third party, on-line trading systems, including but not limited to the Intercontinental Exchange, Bloomberg, California Independent System Operator, New York Mercantile Exchange, or other similar on-line third party systems.
 - B. Purchases from qualified, third party, independent energy brokers.
 - C. Purchases from non-affiliated entities through auctions or a request for proposals ("RFP") process.
 - D. Bilateral contracts with non-affiliated entities.
 - E. Bilateral contracts with affiliated entities, provided that non-affiliated entities are provided notice of and an opportunity to beat any proposed contract before executing the transaction.
 - F. Any other competitive procurement process approved by the Commission.
2. Utilities should seek to use an RFP as the primary acquisition process. Exceptions may include the following:
 - A. For emergencies. The parties to the proceeding were virtually unanimous that a utility should not have to go through either an RFP process or use an independent monitor.
 - B. For short-term acquisitions of less than five years to maintain system reliability.
 - C. For other components of energy procurement, such as transmission projects, fuels and fuel transportation.
 - ~~C. When the planning horizon is two years or less.~~

- D. When a utility encounters a genuine, unanticipated opportunity to acquire a power supply resource at a clear and significant discount when compared with the cost of acquiring new generating facilities that will provide unique value to customers.
 - E. For transactions that satisfy obligations under the Renewable Energy Standard rules and Demand Side Management/ Demand Response programs, purchases from distributed renewable energy resources.
3. Where bilateral negotiations may be the best option to procure long-term resources, such as for resources that require long lead times, the utility must provide written notice to Staff that it is procuring resources outside of an RFP.

Independent Monitor

- 1. An independent monitor should be used in all RFP processes for procurement of new resources.
- 2. The utility should consult with Commission Staff and jointly select create a short list of three to five companies or consultants ("vendor list") who can serve as an independent monitor. The utility should consult with Commission Staff and jointly select an independent monitor for each procurement project.
- 3. The utility will file its vendor list in this docket for interested parties' review. should publicly announce the independent monitor that has been selected and give p Parties will have 30 days to object to the selection of the monitor a vendor's inclusion on the list.
- 4. Within 60 days of the filing of the vendor list, Staff will endorse the vendors it determines are appropriate. Once the vendors are endorsed by Staff, the utility would be able to retain any of the authorized vendors for future RFPs. The utility is required to provide written notice to Staff of its retention of the independent monitor.
- 45. The utility should enter into a contract with the monitor and should pay the monitor. The utility will be allowed to recover the prudent costs of the independent monitor. To the extent that the independent monitor's costs have not been recovered by bidders' fees, the Company will be allowed to defer those costs for recovery in a future regulatory proceeding.
- 56. One week prior to the deadline for submitting bids, issuance of any RFP, the utility should provide the independent monitor with a copy of any bid proposal prepared by the utility or its affiliate, or any benchmark or reference cost the utility has developed against which to evaluate the bids. The independent monitor should take steps to secure the utility bid or benchmark price in a location not known or accessible to any of the bidders or the utility or its affiliate. Once the utility's bid proposal or

benchmark cost is submitted to the independent monitor, utility personnel responsible for developing the benchmark cost or bid proposal may assist in the evaluation of the bids.

7. The independent monitor should provide reports (at least monthly) to Commission Staff throughout the RFP process.