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ARIZONA CORPORATION COMMISSION
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6 Attorneys for Electric Generation Alliance

7 **BEFORE THE ARIZONA CORPORATION COMMISSION**
Arizona Corporation Commission

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9 WILLIAM A. MUNDELL
10 JEFF HATCH-MILLER
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IN THE MATTER OF THE
CONSIDERATION PURSUANT TO A.R.S. §
40-252, TO MODIFY DECISION NO. 67744
RELATING TO THE SELF-BUILD OPTION.

DOCKET NO. E-01345A-07-0420

**NOTICE OF FILING DIRECT
TESTIMONY OF
BEN C. TRAMMELL, JR.**

Pursuant to the procedural order in this matter dated October 7, 2007, the Electric Generation Alliance¹ ("EGA"), hereby submits the direct testimony of Ben C. Trammell, Jr.

Respectfully submitted, this 11th day of January, 2008.

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¹ The "Electric Generation Alliance" is an informal coalition comprising Dynegy Arlington Valley, LLC; LS Power Associates, L.P.; and Harquahala Generating Company.

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2 the foregoing filed this 11th
day of January, 2008, with:

3 Docketing Supervisor
4 Docket Control
5 Arizona Corporation Commission
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6 COPY hand-delivered
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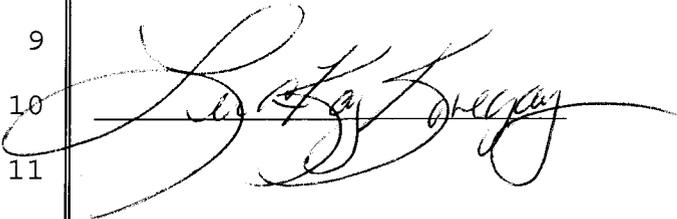
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DIRECT TESTIMONY OF BEN C. TRAMMELL, JR.
On behalf of Electric Generation Alliance
In
Docket No. E-01345A-07-0420

January 11, 2008

1 energy industry, having worked prior to Dynegy for American National Power (a U.S.
2 affiliate of the former National Power PLC, an international wholesale power generation
3 company), Oglethorpe Power Corporation (a rural electric generation & transmission
4 cooperative in Georgia), Southern Company, and the Georgia Tech Research Institute.
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7 **Q-3 What is EGA, and why is it taking an interest in this proceeding?**

8 A-3 The Electric Generation Alliance, or "EGA", is an informal coalition consisting of
9 Dynegy Arlington Valley, LLC; LS Power Associates, L.P.; and Harquahala Generating
10 Company. Each of those entities and their respective affiliates are involved in merchant
11 wholesale electric generation and the power development and marketing business in
12 Arizona. As such, they have a direct interest in the Arizona Corporation Commission's
13 regulatory activities affecting the wholesale electric procurement activities of major load-
14 serving utilities, and specifically Arizona Public Service Company ("APS")
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18 **Q-4 Please summarize your testimony:**

19 A-4 My testimony supports and affirms the direct testimony of Mr. Ted Roberts filed on behalf
20 of Mesquite Power, L.L.C.; Southwestern Power Group II, L.L.C.; and Bowie Power
21 Station, L.L.C.. It is our view, consistent with theirs, that the Commission and its Staff
22 reached generally correct conclusions from the workshops that resulted in the recent
23 adoption of the Recommended Best Practices for Procurement in Order 70032, and that
24 those commendable provisions should be integrated into Order 67744, based upon the
25 rationale set forth in and consistent with Mr. Roberts' testimony. It is our view that the
26

1 Commission should reaffirm its commitment to the principles of inclusion, fairness,
2 transparency, clarity and oversight in the competitive solicitation process.

3 EGA, however, also urges the Commission to make a few additional modifications to
4 better ensure that APS' procurement activities conducted pursuant to Order 67744
5 acquire supply resources on the most competitive terms and in a manner most beneficial
6 to the interests of APS' ratepayers. . Those suggested modifications, simply stated, are as
7 follows:
8

9 (a) that the independent monitor should be hired by and report directly
10 to the Commission, but paid by the Utility;

11 (b) that the independent monitor should function not only as a monitor
12 but also as a bid evaluator;

13 (c) that bidding fees should be capped at a prescribed, nominal level;
14 and
15

16 (d) that a single bidder should be allowed to submit multiple bids
17 under a single bid fee, so as to not discourage multiple, creative
18 and innovative RFP responses "in the alternative" that may meet
19 the needs of the utility and its ratepayers more efficiently than the
20 precise resource response structure contemplated on the face of an
21 RFP.
22

23 (e) that the entire process of bid evaluation by the independent
24 monitor be open by requiring that detailed information about the
25 analysis used to evaluate bids, including the bid evaluation criteria
26

1 and weightings, descriptions of the analytical approach of the
2 evaluation, descriptions of modeling tools used in the evaluation,
3 input data, non-quantitative considerations, and the scoring system
4 for qualitative considerations be available to the public.
5
6

7 **Q-5 Why should the Commission be the contracting party with the independent monitor,**
8 **instead of the utility?**

9 A-5 I understand that, under Order 70032, the Commission and, potentially, interested parties
10 can have an advisory role in the selection of the independent monitor. The frank business
11 reality remains, however, that if APS makes the final selection of, and contracts with, and
12 compensates, the independent monitor, then there is risk that the true objectivity and
13 independence of the selected entity can be compromised, despite the best intentions of the
14 parties to that contract. Experience and human nature have shown that any party
15 controlling the selection, the contracting and the purse strings is likely to be influential in
16 the ultimate work product of the contractor, however independent the structure of the
17 contract or the outward appearances of the parties' joint or separate conduct. The utility
18 appropriately should reimburse the Commission for the costs of hiring the independent
19 monitor, and should appropriately be authorized to recover those costs in rates; but, the
20 Commission needs to select, hire and direct the independent monitor's activities. This
21 concern is even more significant if the independent monitor is, as we urge, given a more
22 substantive role as an evaluator of the bids.
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1 **Q-6 Why are you urging an increased substantive role for the independent monitor?**

2 A-6 Again, my experience in different jurisdictions and various procurement structures is that,
3 if the only duty of an independent monitor is to observe the process, but not question the
4 input assumptions, data, and evaluative modeling tools used by the utility, then the value
5 the monitor adds to the competitive procurement process is severely diminished. Simply
6 monitoring how the utility follows its own, self-determined evaluation process, and having
7 to take as unalterable "givens" all of the input assumptions, data and modeling techniques
8 used by the utility, simply relegates the monitor to little more than a procedural observer.
9 Only blatant process deviations by the utility from its own, self-determined evaluation
10 process would be expected to be reasonably identifiable by the monitor. And any material
11 substantive flaws in the input data, modeling techniques, etc. and, therefore, the ultimate
12 evaluative conclusions, might go unidentified, unless the monitor functions as a truly
13 independent evaluator. That evaluator's role entails having at its disposal all of the utility
14 inputs, assumptions and models, and the ability to challenge and run variables against
15 those, and to generally test the substance of the evaluation, not just the observable conduct
16 of the process. A rough analogy might be to the high school teacher assigned as "study
17 hall monitor". He can do a perfectly good job of observing all the students dutifully
18 working away at their math homework assignments, sitting at the right desks, not having
19 conversations, etc.; yet, the monitor has no clue whether the students are using the right
20 assumptions, equations, tools and techniques to solve their homework problems, much
21 less whether they are arriving at the correct answers. To be of true substantive value to
22 the process of ensuring that the utility is doing the best job it can for its ratepayers, and
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1 making the most economic and prudent resource selections, the monitor needs to be a
2 substantive evaluator and produce a substantive product that tests the substance, not just
3 the process, of the utility's evaluation of responsive resource proposals. This distinction
4 becomes vitally important when, as in this instance, the utility's own "self build"
5 alternative is an option being evaluated.
6

7
8 **Q-7 Why do you urge further Commission direction with respect to bidding fees?**

9 A-7 Order 70032 does provide that "reasonable" bidders' fees may be used to help offset the
10 costs of using an independent monitor. In my experience in other jurisdictions, however,
11 what is "reasonable" to the utility has come to cover a very wide range of dollars. If the
12 utility is allowed to unilaterally set the bidding fees, and, in addition, to charge a separate
13 full fee for each alternative bid that might be provided by a single responding entity in a
14 single procurement, we have found that a chilling effect can occur that constrains the
15 number of bona fide responses to an RFP. Importantly, a bidder should not be
16 discouraged by prohibitively high aggregate "entry fees" against submitting multiple
17 variations of responses to RFPs that suggest to the utility innovative and creative
18 alternative approaches to meeting the resource need. Although such variations might
19 deviate in innovative ways from the strict "four corners" of the RFP, such multiple bids in
20 the alternative may nonetheless present unique and valuable opportunities for the utility
21 and its ratepayers, if are not precluded by the respondents' bidding fee cost concerns. At a
22 minimum, any bid fee structure should provide material discounts for such multiple
23 responsive bids "in the alternative" from a single bidder.
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1 **Q-8 Would an outright prohibition on utility self-build enhance the benefits to ratepayers**
2 **of competitive bidding from wholesale generators?**

3 A-8 Yes, most definitely. When a utility is allowed to compete for a needed generation supply
4 increment with its self-build proposal, and conduct a non-transparent bid
5 evaluation/selection evaluation, history and past outcomes have generally taught the
6 wholesale generation community that third-party competitive bids simply are used as
7 stalking horses to set the price for the self-build. Wholesale generators are understandably
8 reluctant to devote resources to compete in such a bid process when the outcome -- an
9 award for the self-build proposal -- seems pre-determined. In contrast, when a definite
10 need for new supply has been identified and authorized by the cognizant regulatory
11 authority, and no self-build is allowed, by definition some third-party wholesale
12 generation supplier is guaranteed an award. The uncertainty over award (and
13 corresponding potential for waste of scarce resources) is lifted, true competition is created,
14 and a fair outcome is assured. Wholesale generators by their nature thrive on this form of
15 competition, and the benefits of lower cost generation supply (not to mention at-risk
16 capital instead of rate-based cost recovery) accrue to the ratepayers and retail end users.
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20 **Q-9 What risk factors should be considered in comparing a utility self-build project with**
21 **an IPP project?**

22 A-9 In any analysis, it is important to evaluate how a particular risk is allocated between
23 ratepayers, the utility and its shareholders, and the owner of the non-utility project? What
24 are the long-term consequences of the allocation of risks and benefits? What incentive
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26

1 does the party bearing the risk have to manage the risk and how strong is that incentive?
2 What are the consequences for that party of a failure to manage the risk? When these
3 questions are considered and effective comparisons are made, it is the opinion of the EGA
4 that the net benefits for ratepayers of power purchase agreements (PPAs) or non- utility
5 owned projects will clearly emerge. More important, however, is the principle that fair
6 comparisons between utility-sponsored projects and independent power projects (IPPs)
7 can and should be made as part of a fair, transparent, and competitive procurement
8 process.
9

10
11 **Q-10 What are the risks and benefits of utility owned generation versus IPP owned**
12 **generation with respect to ratepayers?**
13

14 A-10 Cost-based rates are sometimes touted as a benefit for ratepayers. The argument in support
15 of this idea is that ratepayers pay no more than the cost of service, while under PPAs the
16 prices are not necessarily closely tied to actual costs. There are several flaws in this
17 argument. First, IPP bids are necessarily closely related to costs. An IPP's bid will include
18 a projection of certain costs, and once the bid is accepted, an IPP is highly incentivized to
19 ensure that actual costs are kept within the projected range. At the same time, competitive
20 market pressures force winning bidders to submit bids as low as possible. By contrast, if a
21 utility-owned plant encounters higher than projected costs, the possibility exists that these
22 higher costs may be passed through to ratepayers. Developers of projects supporting
23 PPAs, on the other hand, have only their contract to fall back on. Any construction cost
24 overruns for an IPP eat directly into its projected profits. IPP companies that fail to meet
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1 profit projections will lose favor with investors, increasing the cost of raising capital and
2 potentially leading to the demise of the company. Independent developers thus have a
3 strong incentive to ensure that plants are completed at or below budget. Similarly, pass-
4 throughs of operation and maintenance expenses and capital additions for utility-owned
5 projects create back-end costs for ratepayers that are not typically present for PPAs.
6

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8 **Q-11 What other risks and benefits of utility owned generation versus IPP owned**
9 **generation with respect to ratepayers are important?**

10 A-11 For utility-owned plants, recovery of capital costs is not closely tied to performance. That
11 is, if the plant has an extended outage, poor performance, or even early retirement, the
12 possibility exists that the utility to will be allowed recover unrecovered capital costs, in
13 the absence of imprudent or unreasonable behavior. For PPAs, however, payment is
14 typically tied to performance. Even contracts that have fixed capacity payments usually
15 include provisions that suspend payments in the event of a sustained outage, premature
16 retirement, or unavailability during times of peak demand. A failure to meet the contract's
17 performance requirements can lead to the assessment of damages or in certain
18 circumstances the termination of the contract. Owners of units under PPAs thus have a
19 strong incentive to maintain the availability of their units.
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23 It is sometimes claimed that an advantage of utility build projects over IPPs is that utility
24 owned plants offer ratepayers greater operational flexibility. They can be run at any time,
25 whenever they are needed. PPAs, the argument continues, may have restrictions on the
26

1 number of starts that can be made without further compensation. This argument is largely
2 misleading. As part of the RFP definition, utilities can require as much (or as little)
3 flexibility as they forecast that they need. Utilities can and do conduct RFPs for
4 dispatchable capacity which can effectively put a plant under the complete control of the
5 purchasing utility. Any cost per start or limitation on the number of starts contained in an
6 offer should be considered as part of the bid evaluation process. Thus, the amount of
7 operational flexibility does not depend on ownership, and the utility can specify the
8 degree of operational flexibility it desires as part of the product definition for the RFP.
9 The real difference between PPAs and utility ownership in this context is that ratepayers
10 are forced to pay for unlimited flexibility for utility owned plants, whether complete
11 flexibility is needed or not, whereas, for PPAs, the utility has the ability to specify in the
12 RFP the level of flexibility (including unlimited flexibility) that it forecasts it will need,
13 and ratepayers will pay only for that amount of flexibility. Thus, the "benefit" of
14 unlimited operational flexibility for utility owned plants comes at a high cost, because
15 ratepayers are forced to pay for operational flexibility beyond what is actually needed.
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18
19 Another argument advanced in favor of utility ownership instead of IPP ownership is that
20 ratepayers get back-end or terminal benefits because a plant's operating life may be longer
21 than its useful life for accounting, tax, and ratemaking purposes. After the plant's capital
22 costs are fully depreciated, this argument goes, the cost to ratepayers of running the plant
23 are only the cost of operation and maintenance and fuel and other variable costs. Units
24 subject to PPAs, on the other hand, typically revert to the owner at the end of the contract,
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1 and ratepayers are then subjected to a need to find replacement power. This argument also
2 ignores some of the downside of utility ownership. Any value a utility-owned plant has
3 near the end of its useful life will depend on whether new technologies have left the plant
4 uneconomic to operate. By way of analogy, the old AT&T at one point owned millions of
5 rotary telephones; but, with the burst of innovation that came with the divestiture of
6 AT&T and the introduction of competition into telecommunications, it is doubtful that
7 there was much residual value to the utility's investment in these phones when they
8 reached the end of their useful lives. Ratepayers' risk of technological obsolescence for
9 PPAs (*i.e.*, that new technologies can produce power at a lower cost) is limited to the term
10 of the contract. The IPP owner bears this risk after contract termination and as this risk
11 increases in the later years of the plant's existence.
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15 Moreover, generating plants eventually reach the end of their lives and have to be
16 decommissioned. The costs of demolition, removal, and environmental remediation for
17 utility owned plants rest on ratepayers, while those costs are borne by the owner of the IPP
18 plant that supports a PPA. If history is any guide, these costs can be considerable.
19 Ratepayers also must bear the cost of keeping these aging plants open during a time when
20 they may not run very often. For an aging independent plant, the decision to continue
21 running or to retire is simple: if the cost of keeping the plant available to run exceeds the
22 expected revenues the plant can earn, either from a contract or through participation in the
23 market, the plant will be retired. For utility-owned plants, cost-of-service ratemaking
24 obscures the economics underlying this decision and can expose ratepayers to
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unwarranted costs.

Finally, a well-structured competitive market will force PPA bidders to account in their bids for any projected residual value at contract expiration, minimizing costs for ratepayers during the term of the PPA.

Q-12 Does that conclude your direct testimony?

A-12 Yes.