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January 30, 2009

Docket Control
Arizona Corporation Commission
1200 West Washington Street
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RE: Arizona Public Service Company's Comments on Retail Electric Competition
Docket No. E-00000A-02-0051 + E-00000A-01-0630

Arizona Corporation Commission Staff held a workshop on retail electric competition on November 14, 2008. At that workshop, Staff requested that the participants file written comments on various topics related to electric competition. Attached are Arizona Public Service Company's comments.

If you have any questions please call Jeff Johnson at 602-250-2661.


Leland R. Snook

Attachments

LS/dt

CC: Barbara Keene
Brian Bozzo
Ernest Johnson
Parties of Record

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Arizona Public Service Company
Electric Competition Workshop Comments
Docket No. E-00000A-02-0051
January 30, 2009

In response to Arizona Corporation Commission (Commission) Decision No. 70485,¹ Commission Staff (Staff) initiated an electric competition workshop process. At the first electric competition workshop held on November 14, 2008, Staff requested that interested parties file written comments in response to questions raised by Staff. Specifically, Staff requested comments regarding the adequacy of the current Retail Electric Competition Rules², whether retail electric competition is in the public interest, an identification of the risks and benefits of adopting retail electric competition, Provider of Last Resort issues, and the costs associated with reinstating Direct Access. Additionally, parties were also invited to comment on any other issues believed to be relevant. Arizona Public Service Company (APS) offers the following comments in response to that request.

Retail Electric Competition Rules

Retail electric competition has been under Commission consideration in various proceedings since the mid-1990s. The Commission first began its consideration of retail electric competition in 1994 which led to the adoption of a set of Retail Electric Competition Rules (Rules) in 1996³ and subsequent amendments to the Rules were adopted in 1998⁴ and 1999.⁵

Since that time, the Commission has issued decisions divergent from the provisions of the Rules, such as "Track A."⁶ Track A required APS and TEP to halt divestiture of its generation assets to a competitive affiliate contrary to provisions in the Rules and also required Staff to open a rulemaking to review the Rules. The Track A decision altered what the Commission had believed was a critical component of the Rules that required incumbent utilities to divest their generation assets.

More recently, the Rules were challenged in the Arizona Court of Appeals. In the *Phelps Dodge*⁷ decision, several sections of the Rules were found by the Court to be either unconstitutional or invalid. In addition, in Commission Decision No. 70485 the Commission recently found that prior to issuing Certificates of Convenience and Necessity (CC&N) for Electric Service Providers (ESP) pursuant to the Rules, the

¹ Application of Sempra Energy Solutions LLC for a Certificate of Convenience and Necessity. Docket No. E-03964A-06-0168

² Arizona Administrative Code R14-2-1601 et seq.

³ Decision No. 59943 (December 26, 1996)

⁴ Decision No. 61272 (December 11, 1998)

⁵ Decision No. 61969 (September 29, 1999)

⁶ Decision No. 65154 (September 10, 2002)

⁷ *Phelps Dodge v Arizona Elec. Power Coop.*, 207 Ariz. 95, 83 P. 3d 573 (App. 2004).

Commission should determine whether the public interest would be served by granting CC&Ns and authorizing competitive services in Arizona.

Clearly, much has changed since the adoption of the most recent set of Rules in 1999. Not only have the rules themselves been called into question by the *Phelps Dodge* decision, but retail competitive markets in the United States have not developed as some had anticipated at the time such markets were first created.

Impact of the Phelps Dodge Decision and the Issuance of Competitive CC&Ns

The Court in *Phelps Dodge* invalidated many of the Rules. In most instances, the legal defects were largely procedural and arguably could be cured by the Commission by submitting portions of a modified set of competition rules to the Attorney General for certification. However, two components of the Rules were invalidated on substantive grounds that would require either legislation, or more likely, a constitutional amendment to reinstate them.

The first was mandatory divestiture of generation. Many states have adopted policies that require generation divestiture as a necessary prerequisite for retail competition, and such was apparently the belief of the Commission when it included such a requirement to the Rules. Whether that is still believed to be an important or even essential consideration in determining the public interest of retail competition must be addressed by the Commission.

The second substantive defect in the Rules was the provision allowing for competitive pricing of retail electric services. Pricing flexibility, along with easy supplier entry to and exit from the market, are generally considered the basic essentials of any competitive market system. Whether *Phelps Dodge* permits the requisite amount of pricing flexibility for retail electric competition is something that might only be resolved through further litigation.

Public Interest Concerns and Evaluation of Benefits

In order to determine if retail electric competition is in the public interest, the Commission should first determine what goals it is attempting to achieve through retail electric competition. Is it increased innovation and efficiency? Is it producing the lowest overall prices? Is it to provide customers with additional and more innovative pricing or service options? Is it to drive prices closer to cost and let "the chips fall where they may" in regards traditional notions of equity as between customer classes? Is it merely to provide customer choice among suppliers? Whether or not any of these goals with the exception of the last has been achieved as a result of retail electric competition in other jurisdictions is open to debate, and there appears to be conflicting evidence from a number of sources.

Having established specific goals for retail electric competition, the Commission should next determine how those goals could best be achieved by incumbent utilities and/or

ESPs consistent with the Commission's recently established policies. For instance, the Commission has adopted a statewide renewable energy standard,⁸ encouraged significant development of demand-side management and energy efficiency programs, and is currently in the process of developing new resource planning rules.⁹

Considerations and Impacts - Retail Electric Competition

Wholesale Market Development

An essential element of successful retail competition is a well functioning competitive wholesale market. A key component to adopting competition at wholesale level includes participation in centralized electricity markets operated by independent regional transmission organizations (RTO) or independent system operators (ISO). To date, the southwestern wholesale market has not developed as anticipated when the Rules were adopted as the formation of RTOs or ISOs have not occurred.

Resource Planning Impacts

One of the major risks of implementing retail electric competition is that long-term utility resource planning objectives for transmission and generation are more difficult to achieve within a competitive framework due to the uncertainty of customer migration to and from retail generation suppliers. Resource planning is vital to developing long-term energy plans for the State, and the current competitive market does not purport to provide a suitable alternative to this planning function.¹⁰ With the greater uncertainty and risks of a competitive retail market, both the incumbent utilities and competitive suppliers will reduce financial risk by gravitating towards generation investments with a shorter-term focus. This could result in a decrease in the development of capital intensive baseload assets or renewable energy sources, similar to what occurred during Arizona's first experience with retail electric competition. Under retail competition, the incumbent utility as Provider of Last Resort has a diminished ability to economically plan for long-term resources and can only pass costs of maintaining an excess of supply reserves on to its remaining Standard Offer customers.

In addition, without stringent switching rules, it will become increasingly difficult for the incumbent utility to conduct effective commodity hedging activities due to the uncertainty associated with the customer migration. This will likely expose the Standard Offer customers to increasing levels of generation price risk and volatility.

⁸ Arizona Administrative Code AAC R14-2-1801 et seq.

⁹ Docket No. E-00000E-05-0431

¹⁰ For example, in many RTO/ISO systems, formal capacity markets have been or are being developed, or specific regulatory policies for long-term resource adequacy or procurement have been created, to reduce reliance on spot markets for retail supply.

Renewables and Energy Efficiency

The Commission has established public policy goals of promoting renewables and energy efficiency. Under retail competition, the costs passed on to Standard Offer customers for the development of large renewable projects or energy efficiency projects could be higher as customers leave the incumbent utilities system. However, this impact could be ameliorated if renewable energy standards and demand-side management/energy efficiency obligations are also applied to competitive retail suppliers. Such an approach would eliminate the artificial incentive to leave the incumbent utility as a way of avoiding the incumbent's charges for renewable energy and energy efficiency.

Reinstitution of Direct Access

It has been approximately 8 years since retail competition has been active. APS anticipates that the Direct Access functions that must be established prior to the onset of competition can be reinstated, but will require updates, system changes, or redevelopment due to changes in technology and computer system interfaces. APS will require additional staff and staff training, computer systems, as well as computer programming. The actual costs of reinstating Direct Access functions will depend on the market structure required by any future retail competition rules ultimately adopted by the Commission and the number and type of customers switching to Direct Access.

Along with the updating of systems and processes to facilitate Direct Access, the Statewide Standards and processes established by the Process Standardization Working Group¹¹ (PSWG) for switching customers from Standard Offer to Direct Access should also be revisited.

¹¹Decision No. 61969 (September 29, 1999). The PSWG is a stakeholder group that was established to develop transaction process necessary to facilitate retail competition.

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