



Arizona Utility Investors Association

2100 N. Central, Ste. 210
P.O. Box 34805
Phoenix, AZ 85067

Tel: (602) 257-9200
Fax: (602) 254-4300

Email: info@auia.org
Web Site: www.auia.org

BEFORE THE ARIZONA CORPORAT

WILLIAM A. MUNDELL
CHAIRMAN
JIM IRVIN
COMMISSIONER
MARC SPITZER
COMMISSIONER

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IN THE MATTER OF ARIZONA PUBLIC SERVICE)	DOCKET NO. COMMISSION
COMPANY'S REQUEST FOR A VARIANCE OF)	E-01345A-01-0822 CONTROL
<u>CERTAIN REQUIREMENTS OF A.A.C. R14-2-1606</u>)	
IN THE MATTER OF THE GENERIC PROCEEDINGS)	DOCKET NO.
<u>CONCERNING ELECTRIC RESTRUCTURING.</u>)	E-00000A-02-0051
IN THE MATTER OF TUCSON ELECTRIC POWER)	
COMPANY'S APPLICATION FOR A VARIANCE OF)	DOCKET NO.
CERTAIN ELECTRIC COMPETITION RULES)	E-01933A-02-0069
<u>COMPLIANCE DATES.</u>)	
IN THE MATTER OF THE APPLICATION OF)	DOCKET NO.
TUCSON ELECTRIC POWER COMPANY FOR)	E-01933A-98-0471
<u>APPROVAL OF ITS STRANDED COST RECOVERY.</u>)	
IN THE MATTER OF THE GENERIC PROCEEDING)	DOCKET NO.
CONCERNING THE ARIZONA INDEPENDENT)	E-00000A-01-0630
<u>SCHEDULING ADMINISTRATOR</u>)	

NOTICE OF FILING

The Arizona Utility Investors Association hereby provides notice of filing the Direct Testimony of Walter W. Meek as required by the Commission's procedural order in the above-captioned matter, dated February 8, 2002..

DATED THIS 29TH DAY OF MARCH, 2002.

WALTER W. MEEK, PRESIDENT

CERTIFICATE OF SERVICE

Original and eighteen (18) copies of the referenced Testimony were filed this 29th day of March, 2002, with:

Docket Control
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Copies of the referenced Testimony were hand-delivered this 29th day of March, 2002, to:

Arizona Corporation Commission

DOCKETED

MAR 29 2002

DOCKETED BY

William A. Mundell, Chairman
Hercules Dellas, Esq.
James M. Irvin, Commissioner
Patrick Black, Esq.
Marc Spitzer, Commissioner
Paul Walker, Esq.
Christopher Kempley, Esq., Legal Division
Ernest Johnson, Esq., Utilities Division
Lyn Farmer, Esq., Hearing Division
Arizona Corporation Commission
1200 W. Washington
Phoenix, AZ 85007

Copies of the referenced Testimony
Were faxed or mailed this 29th day of
March, 2002, to:

Appropriate parties of record

1 DIRECT TESTIMONY

2 OF

3 WALTER W. MEEK

4
5
6
7 I. Introduction

8
9 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

10 A. My name is Walter W. Meek. My business address is 2100 North Central
11 Avenue, Suite 210, Phoenix, Arizona 85004.

12
13 Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

14 A. I am the president of the Arizona Utility Investors Association ("AUIA"
15 or "Association"), a non-profit organization formed to represent the
16 interests of shareholders and bondholders who are invested in utility
17 companies that are based in or do business in the state of Arizona.

18
19 Q. ARE SOME AUIA MEMBERS SHAREHOLDERS OF PINNACLE WEST
20 CAPITAL CORPORATION?

21 A. Yes. AUIA has approximately 6,000 members and a substantial
22 percentage are common shareholders of Pinnacle West Capital
23 Corporation ("PWCC"), the corporate parent of Arizona Public Service
24 Company ("APS").

25
26 Q. WHAT IS YOUR BACKGROUND IN REPRESENTING SHAREHOLDER
27 CONCERNS AND INTERESTS?

28 A. I have been president of AUIA for nearly eight years. Prior to that, my
29 consulting firm managed the affairs of the Pinnacle West Shareholders
30 Association for 13 years. During this time we have represented
31 shareholders in numerous rate cases and other regulatory matters and
32 have published many position papers, newsletters and other documents
33 in support of shareholder interests.

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Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I am here to represent the views of the equity owners of PWCC regarding the issues raised by the APS request for a variance from the Commission's electric competition rules.

Q. WHAT IS AUIA'S POSITION?

A. We urge the Commission to grant APS a variance from the requirement contained in R14-2-1606(B) that the company subject 50 percent of its load to competitive bid beginning in 2003. We are convinced that a variance would be in the public interest.

Q. DO YOU SUPPORT THE PROPOSED PURCHASED POWER AGREEMENT?

A. We are more ambivalent about the proposed PPA, although we believe it is far superior to the bid requirement. The competition rules require APS to transfer its generation assets to a separate affiliate. If the Commission is concerned about keeping the company's generation assets committed to serving the APS load, the PPA is a good solution. AUIA has no firm positions on the contractual elements of the PPA.

I. The Competition Rules Were Based on False Assumptions.

Q. WAS AUIA INVOLVED IN THE COMPETITION RULEMAKING?

A. Yes. We were involved from the opening of the retail competition docket until the current rules were adopted. We were involved in hundreds of hours of workshops and we intervened in the generic stranded cost proceeding and four separate stranded cost dockets. All of this took nearly six years of effort.

Q. ARE THERE PROBLEMS WITH THE RULES?

A. Yes, there are several, beginning with the fact that the entire rulemaking product was based on false assumptions.

- 1 Q. WHAT WERE SOME OF THESE ASSUMPTIONS?
- 2 A. First, that the western grid harbored significant excess generating
3 capacity. Second, that low-cost supplies of natural gas would be
4 plentiful. Third, that open access would spur a robust wholesale market.
5 And, that the advent of retail competition would be accompanied by
6 rapid price decreases. Proponents of deregulating generation told this
7 Commission that they could expect cost savings of up to 40 percent
8 resulting from competition.
9
- 10 Q. WHAT WAS THE FATE OF THESE ASSUMPTIONS?
- 11 A. All of them melted down in the summer of 2000. Supplies throughout
12 the west proved to be deficient, sending wholesale prices to unheard of
13 levels. Natural gas supplies were constrained and prices reached record
14 levels. The non-municipal portion of California's electric industry
15 experienced financial disaster and the state government is now
16 underwriting the system. Finally, non-municipal electric customers
17 received huge rate increases in 2001.
18
- 19 Q. WHAT HAPPENED TO RETAIL COMPETITION?
- 20 A. In California, it died an ugly death. The California Public Utilities
21 Commission officially pulled the plug on retail competition last
22 September. In other western states, competition is dead or on hold.
23
- 24 Q. WHAT WAS THE ARIZONA EXPERIENCE?
- 25 A. Arizona was largely shielded from the worst effects, including the price
26 spikes that were experienced throughout the west, but the net effect was
27 that competition never happened here.
28
- 29 Q. WHAT SHIELDED ARIZONA FROM PRICE SPIKES?
- 30 A. A few things. Arizona's approach to deregulation didn't replicate some
31 of the provisions that proved to be disastrous in California, such as
32 forced purchases through a central power exchange. Also, the terms of

1 stranded cost settlements that were reached here prohibited retail price
2 increases. And finally, Arizona utilities were better equipped than most
3 western utilities to meet load requirements with their own resources
4 and were less at the mercy of the volatile wholesale market.

5
6 Q. WERE THERE SOME EXCEPTIONS?

7 A. Yes. Severe price hikes were experienced by two Arizona tribal entities
8 and by Citizens Communications in serving its 75,000 customers in
9 Mohave and Santa Cruz counties.

10
11 Q. WHY DID THESE EXCEPTIONS OCCUR?

12 A. Each of these entities lacks generation capability and has to rely on
13 purchased power to serve its load. Citizens, for example, has an all
14 requirements contract with APS. Unfortunately, the terms of that
15 contract exposed Citizens to some of the market chaos that erupted in
16 2000 and 2001, to the extent that Citizens has paid more than \$100
17 million in excess power costs that it can't collect from its customers.

18
19 Q. WHAT KEPT COMPETITION FROM OCCURRING IN ARIZONA?

20 A. Simply put, wholesale prices were too high and there was too much risk
21 for large users and aggregators to venture into the market, especially
22 when Arizona was an island of tranquility where prices were stable or
23 going down.

24
25 **II. The Bidding Requirement Places Shareholders and Ratepayers At Risk.**

26
27 Q. WHY DOES AUIA OPPOSE THE BIDDING REQUIREMENT?

28 A. In general, because it is bad public policy that has not been subjected to
29 any scrutiny or market analysis, but we have several specific reasons:
30 • In the circumstances, it is patently unfair to the company and it places
31 its shareholders at significant financial risk.

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- In the long run, APS ratepayers will also be at risk for price fluctuations and reliability failures.
- There is no guidance in the rules about how to conduct the bidding, but APS will be held liable by the Commission if it goes badly.
- The bid requirement does nothing to advance retail competition and may inhibit it.
- Instead, it is a potentially imprudent foray by the Commission into the wholesale electric markets.
- The Commission should consider that the resulting contract(s) would fall under the jurisdiction of the Federal Energy Regulatory Commission (FERC).
- The Commission should also realize that in order to participate in the bidding specified in the rules, APS must divest its generation.

Q. WHY IS IT UNFAIR TO THE COMPANY AND ITS SHAREHOLDERS?

A. Under the rules, APS is the provider of last resort for all of its Standard Offer customers. That means that it must deliver electric service to every customer that is not served by a competitive provider. As we noted earlier, there is no competition in Arizona and every electric utility, including APS, has had to plan and act as if it will continue to have full responsibility for supplying power to its entire customer base.

Q. WHAT IS THE PRACTICAL EFFECT OF THAT RESPONSIBILITY?

A. In APS's case, it has had to invest or commit to investments totalling approximately \$1 billion to keep even with load growth. If APS is required to bid out 50 percent of its load, that investment will be at significant risk.

Q. HOW DOES IT BECOME AT RISK?

A. APS's loads and resources are essentially at equilibrium. If some portion of its load is underbid by merchant generators, an equivalent amount of

1 its generation will be relegated to the wholesale market where there may
2 or may not be a viable market for its output.

3
4 Q. IS THIS OF CONCERN TO THE FINANCIAL MARKETS?

5 A. Yes. I have had conversations with analysts, institutional shareholders
6 and hedge fund managers who are very concerned about these
7 investments as PWCC approaches 2003.

8
9 Q. IN WHAT WAY IS THE BIDDING REQUIREMENT DIFFERENT FROM
10 THE REST OF THE COMPETITION RULES?

11 A. It is one thing to require a utility to open its service territory to retail
12 competition with ground rules that allow consumers and utilities to
13 make reasoned decisions based on economic choices. It is quite another
14 to set up a situation in which the utility may be forced to gamble in the
15 wholesale market with generation it has built to serve customers.

16
17 Q. HOW WOULD THE BIDDING REQUIREMENT EXPOSE RATEPAYERS
18 TO PRICE RISKS?

19 A. In the first place, there is no guarantee that bid prices for generation
20 would be lower than APS is experiencing now. Once the bidding process
21 is underway, APS will simply have to accept what it gets. If the bids are
22 higher than APS's current cost of generation, the customers will have to
23 pay the difference. Under the rule, there would be no opportunity to go
24 back to the APS portofolio.

25
26 Q. HOW ELSE WOULD BIDDING CREATE PRICE RISKS?

27 A. If any significant portion of APS's generation was displaced through
28 bidding, APS would immediately seek to sell the displaced generation in
29 the wholesale market, perhaps on long-term contracts. In two or three
30 years, when the competitive bidding contracts were due to expire,
31 market prices could be higher and the displaced APS generation would

1 no longer be available. As a result, APS customers would have to pay
2 whatever the market required.

3

4 Q. COULD WE REPEAT THE EXPERIENCE OF CITIZENS
5 COMMUNICATIONS ON A LARGER SCALE?

6 A. That would seem to be an extreme scenario, but the western energy
7 markets are still in serious flux and the future could be very dangerous.

8

9 Q. HOW WOULD RATEPAYERS BE EXPOSED TO RELIABILITY RISKS?

10 A. In the example I just gave, it is possible that when the contracts that
11 resulted from bidding expired, tight market conditions might prevail
12 and the suppliers would be motivated to move to greener pastures. If
13 APS had no generation available to plug the gap, it might not be able to
14 keep the lights on. Clearly, if bidding goes forward, APS or PWCC can't
15 keep building capacity to protect against that contingency.

16

17 Q. ARE THERE RISKS IN THE BIDDING PROCESS?

18 A. The competition rules contain no guidance on how the bidding should
19 be structured and there have been no workshops on the subject. This
20 Commission has workshopped everything from meter reading to gas
21 procurement, yet the state's largest utility is expected to auction off half
22 of its load with no guidance at all.

23

24 Q. WHAT ARE SOME ISSUES THAT ARE UNCLEAR?

25 A. For example, it's not clear in the rules whether APS is required to bid out
26 half of its peak load or half of its annual load. I think we can assume
27 that APS will seek bids for firm power with adequate reserves, but they
28 are on their own with regard to terms and conditions and there is no
29 assurance that they will be acceptable to potential bidders or the
30 Commission.

31

32

1 Q. ARE THERE RISKS OF DEFAULT?

2 A. Enron has proved that in spades. The Enron lesson is that you can have
3 a contract with very favorable terms that is no better than the financial
4 resources that stand behind it. If there is a default, you may have to
5 execute your claim for damages against a pile of shredded paper.
6

7 Q. ARE THERE NO PROTECTIONS IN THE COMPETITION RULES?

8 A. The rules are designed for retail competition, so there are provisions
9 dealing with Standard Offer service and the departure and return of
10 customer loads on the distribution system. However, there are no
11 protections against defaulting wholesale suppliers. After all, the
12 Commission has no jurisdiction over wholesale contracts.
13

14 **III. Enforced Bidding Will Not Encourage Retail Competition.**
15

16 Q. WILL THE BID REQUIREMENT FACILITATE COMPETITION?

17 A. Ironically, the Commission competition rules were designed to enable
18 retail competition and they do that. But the bidding requirement has
19 nothing to do with retail competition and may help to stifle it.
20

21 Q. WHERE DID THE IDEA ORIGINATE?

22 A. That is another irony. It was offered at the last minute in the
23 competition rulemaking by Enron, which later crashed into oblivion
24 owing APS some \$15 million.
25

26 Q. HOW WILL THE BID REQUIREMENT AFFECT COMPETITION?

27 A. If it is successful to any degree in displacing APS generation, the bid
28 requirement will benefit only a few merchant generators who have the
29 ability to reach the Phoenix load pocket. These generators will be able to
30 sell into the Phoenix market with APS as their wholesale customer.
31 Any minimal contribution this makes to competition will be at the
32 wholesale level. They will completely avoid any of the transaction costs

1 that would normally be associated with retail sales. In that respect, it
2 would be a phony brand of competition.

3
4 Q. HOW WOULD THIS INHIBIT RETAIL COMPETITION?

5 A. Assuming for the sake of argument that marginally lower costs can be
6 achieved in the short term through wholesale bidding, why would
7 consumers or suppliers want to take on the additional hassles and
8 transaction costs associated with retail competition?

9
10 Q. WHY WOULD THE COMMISSION PROMOTE WHOLESALE
11 TRANSACTIONS?

12 A. It shouldn't. The merchant plants would like the Commission to
13 believe that it is responsible for their well-being, but that is absurd. The
14 Commission's responsibility is to Arizona consumers and the
15 companies that it regulates. It has no responsibility whatsoever for the
16 fortunes of merchant generators.

17
18 Q. BUT WEREN'T MERCHANT PLANTS BUILT ON THE EXPECTATION
19 THAT THE BIDDING REQUIREMENT WOULD BE CARRIED OUT?

20 A. Some of them make that claim today, but it would have been a very bad
21 business decision to have built one of these plants on that basis. Most of
22 these plants were built to serve California and other western markets
23 and most of them are constrained by lack of transmission into Phoenix.
24 If metropolitan Phoenix was their target, they should have built inside
25 the load pocket as APS and Salt River Project are doing.

26
27 Q. WHO WOULD HAVE JURISDICTION OVER THE TRANSACTIONS?

28 A. The merchant plants are exempt wholesale generators under the
29 jurisdiction of FERC. The contracts resulting from the bidding would
30 also be under FERC jurisdiction.

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Q. WOULD APS HAVE TO DIVEST ITS GENERATION?

A. The competition rules anticipate that the existing generating plants that serve APS customers would participate in the competitive bidding, but to assure an arms' length bidding process, APS would have to divest its generation into a Pinnacle West affiliate.

IV. The Variance Is Appropriate and in the Public Interest.

Q. WHY IS THE PROPOSED VARIANCE IN THE PUBLIC INTEREST?

A. The bidding process would subject APS customers to unknown risks, exposing them to the vagaries of an immature and unpredictable wholesale market which failed badly to serve the public interest during the past two years. The market continues to be unpredictable, but once the bidding process has been unleashed, there would be no turning back. Action to prevent this leap into the unknown is clearly in the public interest.

Q. IS THE VARIANCE PERMITTED BY THE ELECTRIC COMPETITION RULES?

A. Absolutely. A.A.C. R14-2-1816(C) authorizes the Commission to grant "variances or exemptions" to the rules.

Q. IS THE BIDDING REQUIREMENT A "CORNERSTONE" OF THE COMPETITION RULES, AS SOME HAVE SAID?

A. No. In the rulemaking, it was an afterthought, a last-minute amendment promoted by a company that is now irrelevant. Understandably, the merchant generators are now trying to use it to their advantage. Under the requirements of the Administrative Procedures Act, if the addition of the bidding requirement had been deemed a major amendment, it would have to have been noticed as such prior to its consideration. It was not.

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Q. DOES THE VARIANCE VIOLATE THE APS STRANDED COST SETTLEMENT AGREEMENT, AS SOME HAVE ALLEGED?

A. No. The settlement agreement does not require APS to engage in competitive bidding or acquire any particular percentage of its load requirements in the competitive market. The agreement simply requires APS to follow the Commission's rules in procuring energy for its Standard Offer customers. Obviously, the agreement could not have foreclosed the Commission from amending the rules or granting variances and exemptions, as requested here.

Q. WHO WOULD BE HURT BY THE PROPOSED VARIANCE?

A. No one. Merchant plants were built specifically to operate in the western wholesale markets and they have no right to expect the Arizona Corporation Commission to create a customer base for them.

Q. WOULD YOU CLARIFY AUIA'S POSITION ON THE PROPOSED PURCHASED POWER AGREEMENT?

A. AUIA is not well positioned to analyze the specific elements – particularly the pricing and longevity – of the PPA. However, we believe the concept is infinitely superior to the bidding requirement in 1606(B). The PPA would add stability and lower risk for shareholders and customers alike, while advancing competition at a measured pace.

Q. PLEASE COMMENT ON THE SUGGESTION THAT APS SHOULD SOLICIT BIDS WHICH COULD BE COMPARED WITH THE PPA PRICE.

A. It can't be done. There is no valid comparison between them. The PPA is a long-term power supply agreement, which would supply 6,000 megawatts from a balanced portfolio of generation resources, with protection against market contingencies. The bids would cover two or three years, in increments of a few hundred megawatts from a single fuel source. Besides, there are considerations other than price.

1 Q. IS RELIABILITY ONE OF THOSE CONSIDERATIONS?

2 A. Yes. The reliability inherent in the PPA's fuel diversity is one of its most
3 attractive features. Potential bidders would have to rely exclusively on
4 generation from natural gas, which has shown itself to be extremely
5 volatile, both as to price and availability. Pipeline capacity is at a
6 premium and gas supplies can be curtailed.

7
8 Q. HOW WOULD APS PARTICIPATE IN COMPETITIVE BIDDING?

9 A. It couldn't. It would be running the bid process. In order to have a
10 neutral process (not tainted by conflict of interest), APS would have to
11 divest its generation assets to a separate PWCC affiliate which could then
12 participate at arms length.

13
14 Q. WOULD A PWCC OFFER LOOK DIFFERENT FROM THE PPA?

15 A. Yes. First, it would have to conform to the bid requirements and would
16 undoubtedly cover a much shorter time frame than the PPA. In
17 addition, PWCC would offer a mix of resources that would fit its view of
18 the short-term energy markets. Like the other bids, the PWCC package
19 probably would offer less stability and certainty than the PPA.

20
21 **V. Conclusion**

22
23 Q. DO YOU HAVE ANY CONCLUDING REMARKS?

24 A. Yes. Imagine that it is May of 2000 and APS has just dumped one-half of
25 its customer load onto the open market for competitive bidding. It has
26 divested its generation and PWCC expects to be one of the bidders. But
27 just to be safe, PWCC is diligently pursuing other buyers. Suddenly,
28 unexpected market forces converge and prices surge. APS receives
29 outrageous bids and PWCC is rapidly disposing of its capacity. It's
30 Citizens Communications times ten.

31

1 Is this a far-fetched scenario? We don't know. What we do know is that
2 price volatility continued through much of 2001; the gas and electric
3 supply scenarios in the west are still in play; and the wholesale market
4 failed its last serious test.

5
6 The bidding requirement in 1606(B) is a three-year-old provision that
7 received no analysis or in-depth consideration when it was proposed by
8 Enron. There has been no Commission analysis to date of market
9 conditions that would bear on this requirement. Absent such an
10 analysis, this is arguably the worst time possible to shoot craps in the
11 wholesale market with half of APS's customer load.

12
13 The Commission should grant the APS request for a variance.

14

15 Q. DOES THAT CONCLUDE YOUR TESTIMONY?

16 A. Yes, it does.

17

18