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AZ CORP COMMISSION
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June 14, 2002

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

RE: WITNESS SUMMARY OF PREFILED TESTIMONY UNDER DOCKET NUMBERS
E-00000A-02-0051, E-01345A-01-0822; E-00000A-01-0630; E-01933A-02-0069;
E-01933A-98-0471

Dear Sir or Madam:

Pursuant to the Procedural Order dated May 2, 2002, for the above referenced Docket Numbers, Arizona Public Service Company ("APS") is hereby filing the written summary for Mr. Jack Davis, Dr. William Hieronymus, Mr. Cary Deise and Dr. Charles Cicchetti.

If you or your staff have any questions, please feel free to call me.

Sincerely,

Jana Van Ness
Manager
State Regulation

Attachment

JVN/vld

Cc: Docket Control (Original, plus 18 copies)

Arizona Corporation Commission
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Testimony Summaries

**Arizona Public Service Company
Docket No. E-00000A-02-0051, et al.**

June 14, 2002

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Summary of Jack Davis Direct Testimony

The Commission's Electric Competition Rules (A.A.C. R14-2-1601, *et seq.*) specifically mandated divestiture of all APS generation assets by December 31, 2000. At the Company's request, this divestiture was both expressly authorized by the Commission and postponed by up to two years as a result of the 1999 APS Settlement Agreement, which settlement was approved and adopted by the Commission in Decision No. 61973 (October 6, 1999). An earlier settlement agreement negotiated with Commission Staff in 1998 but eventually withdrawn, also provided for divestiture of APS generation to an affiliated entity. The reasons prompting these various actions by the Commission and Staff are as valid today as they were in 1998 and 1999.

They also explain why the divestiture of generation by electric utilities to subsidiaries or other affiliated entities has been a common part of industry restructuring in other jurisdictions. The Commission has had in place comprehensive Affiliate Rules (A.A.C. R14-2-801, *et seq.*) since 1990. Affiliate transactions are also reviewed in individual proceedings, both rate and otherwise. Similarly, the Commission and FERC have approved Codes of Conduct. In addition, APS has in place implementing Policies & Procedures (Commission) for its Commission-approved Code of Conduct and Standards of Conduct (FERC) that govern the interaction between affiliated merchant energy functions (e.g., Pinnacle West Marketing & Trading ("PWM&T")) and the wire (transmission) functions of APS. These existing regulatory policies and powers have proven effective as to those utilities covered by such provisions.

Finally, I am aware that sales to APS of power from the wholesale electric market are regulated by FERC. This has been true since long before I came to the Company, and I am not aware of any proposals to change this jurisdictional fact of life. That does not mean, however, that the Commission is powerless to either

effectively participate in FERC proceedings affecting Arizona consumers or that it has surrendered its ability to review discretionary decisions by APS management to determine whether they were prudent given the facts and circumstances known to APS at the time such decisions were made.

Summary of Jack Davis Rebuttal Testimony

Procedurally, the adoption of Staff's recommendations will prevent the Commission from resolving any of the threshold issues identified by the Company in its Motion of April 19, 2002 prior to year's end, let alone within the time established by both the Commissioners themselves at the April 25, 2002 Special Open Meeting and by the Chief Administrative Law Judge's Procedural Order dated May 2, 2002. Many of the recommendations could not even be implemented in this docket because they would necessitate separate rulemaking proceedings.

Substantively, Staff would have this Commission undo virtually every provision and reverse virtually every finding from the 1999 APS Settlement Agreement, excepting, of course, the rate reductions, the \$234 million write-off and other concessions made by the Company in the course of such Settlement. Indeed, the very existence of the 1999 APS Settlement is barely acknowledged. As noted in my Rebuttal Testimony in the Variance Docket, the 1999 Settlement Agreement involved the Commission itself as a party and has been characterized as a binding contract with the Commission by the Arizona Court of Appeals. And in the place of the very Settlement that has allowed Arizona to move forward towards a restructured and competitive electric industry without the sort of economic disruptions that have erupted almost everywhere else in the Western United States, Staff proposes a bizarre and oppressive form of "regulated competition" that is neither competition nor traditional regulation and which will utterly fail to provide consumers the benefits of either regime. It is premised on a "lower of cost or market" philosophy that this Commission and others have repeatedly rejected and which is inherently unreasonable, inequitable and unsustainable.

Taken in combination with the suggestions of the Merchant Intervenors, Staff's recommendations are more likely to lead to a repeat of California than to the reliable service at just and reasonable rates that Staff professes to be its

objective. This is because Staff's position represents a complete failure to recognize the essentials of a competitive market or to acknowledge the regulatory bargain inherent in traditional cost-of-service regulation. Furthermore, Staff has ignored the practical aspects of efficiently and reliably planning and operating an electrical system, as is discussed at length in Mr. Deise's Rebuttal Testimony.

Staff's testimony is all the more puzzling to the Company because the very Proposed PPA that Staff has spent so much effort opposing would, in fact, answer many if not most of Staff's stated concerns. And although I am aware that the Commission has stayed proceedings in the Variance Docket, I would be doing the Company's customers a great disservice if I did not point this paradox out to the Commission in my Rebuttal Testimony.

While Staff's testimony was, to put it mildly, greatly disturbing, that of the Merchant Intervenors was, for the most part predictable, self-interested and procedurally inappropriate. The "Track A" issues about which they originally expressed no opinion back in December of 2001 now become a new source of leverage in "Track B." The Pinnacle West Energy Corporation ("PWEC") that they bravely challenged to open competition in December 2001 now becomes some form of market "superpower" that must be restrained from meaningful competition with the Merchant Intervenors. Rather than support the Company's original request to resolve "Track A" and "Track B" issues in a single proceeding or acquiesce to the Commission's decision to address them separately, the Merchant Intervenors apparently want two turns at bat, once in this proceeding and another in the "Track B" proceeding. What is new is the Merchant Intervenors new-found interest in delay, since many of their proposals are so radically different than anything heretofore proposed in this jurisdiction that they could likely not be in place even by the summer of 2003. This is in stark contrast to a group that as recently as April of this year urged the Commission to immediately order APS to begin competitive bidding.

Staff's continued disregard for the 1999 APS Settlement is obviously contagious. Residential Utility Consumer Office ("RUCO") witness Dr. Richard Rosen would have the Commission abandon competition and return to traditional regulation if the Commission is unwilling to consider a long-term buyback from the Dedicated Assets similar to that already before the Commission in the form of the Proposed PPA. Although a principled position in the abstract, it ignores that fact that Dr. Rosen's client is bound by the 1999 APS Settlement, which itself imposed no requirement for a PPA of any sort, let alone one as favorable to consumers as the Proposed PPA. Dr. Rosen also expresses concern that PWEC or PWM&T might engage in "capacity withholding" or "bid gaming" if unrestrained by a long-term PPA with APS. Although the Proposed PPA is in the interests of APS customers, a fact recognized by Dr. Rosen, even in its absence there is no reason to believe that APS affiliates would engage in such activities or that regulators, state and federal, would tolerate them.

Arizonans for Electric Choice and Competition ("AECC") witness Kevin Higgins generally presents a balanced recommendation that both recognizes AECC's responsibility to uphold the 1999 APS Settlement and urges appropriate vigilance regarding the wholesale electric market. While APS and the AECC will apparently continue to have disagreements over the particulars of the proposed PPA, we do not appear to have major disagreements in this phase of the Generic Docket.

Summary of Dr. William Hieronymus Direct Testimony

The separation of APS's generation is in the public interest because the public interest is best served by the creation of a liquid and vibrant competitive wholesale market. Severing the vertical connections between generation and transmission materially facilitates the creation of a competitive wholesale market by reducing concerns about the exercise of vertical market power. Eliminating unitary ratemaking over the various portions of the utility enterprise, especially the full separation of the generation entity from the distribution and customer service entity, eliminates cross-subsidization concerns.

The benefits of a competitive wholesale market flow primarily from three causes. First, the progressive movement from cost of service to market pricing produces powerful efficiency incentives that did not exist previously. Related to this is the improvement in management decision making for competitive services as more profit-oriented managements replace utility monopoly managements and their regulators as decision makers concerning what to build, how to contract for fuels, and how to operate generating facilities. Second, a competitive wholesale market allows customers to benefit as competition among efficient generators drives down prices relative to what they would have been under continued monopoly regulation. Third, a competitive wholesale market is an essential underpinning of retail competition and, with it, the product and pricing innovations that retail competition can produce.

Within the context of the WSCC market area, there can be a competitive market even if APS remains an "old fashioned" utility, vertically integrating load and generation. However, APS's customers will not be allowed to benefit from either the wholesale or retail competitive alternatives if this occurs.

The experience with gas deregulation taught the lesson that separation of the control of the transmission network from the control of bulk energy supply is an essential element of creating a competitive wholesale market. Beginning with

Order No. 888 and continuing on through the current campaign to cause all electric transmission to be controlled by RTOs that are independent of generation-owning entities, this separation of generation from transmission has been the main theme of FERC policies to promote competitive wholesale markets.

Because the bulk of existing generation is, or was, owned by vertically integrated utilities, the creation of a vibrant wholesale market also is facilitated by reducing the connection between a utility's existing generation and its load. Separation of competitive generation from remaining regulated monopoly entities is necessary to eliminate potential cross-subsidies that could interfere with both wholesale and retail competition

I am aware that recent events in areas near Arizona have tarnished the image of the value of market restructuring. I believe that, allegations of misbehavior notwithstanding, the specific events of 2000-2001 in the WSCC arose from a very unusual combination of events that are unlikely to recur simultaneously and must be understood in that context. It is notable that other policy decision makers have not been fazed by the California experience. The movement away from the regulated monopoly model to the competitive market model has only marginally slackened its pace. In most of the U.S., in Europe, Asia, South America and parts of Africa, indeed even in a number of formerly communist countries, the belief that competitive wholesale and retail energy markets are superior to regulated monopoly remains unshaken.

Turning to the second topic of my testimony, potential market power in a competitive market and the potential market power that a post-divestiture PWEC might be alleged to have, this issue is difficult to summarize easily. As a general matter, PWEC, even if it had full authority to sell power from the entire fleet of its assets (including those to be transferred) would lack market power in relevant regional power markets, since its share of such markets is small and those markets are structurally competitive, and will remain so after divestiture. Moreover, the

Pinnacle West companies are not in fact free to sell their power at market rates. Currently, the Pinnacle West companies only have power to sell during off-peak periods. Completion of Red Hawk Units 1 and 2, and West Phoenix Unit 5 will somewhat improve its balance between load and resources. However, load growth in Arizona is so rapid that these units will be absorbed before they are on line, with the result that Pinnacle West still will have insufficient resources owned or under current contract to serve 2003 loads reliably while making sales during most near peak periods. In off-peak periods, they will have power to sell, but so will many other sellers. Hence, these shoulder and off-peak markets will be vigorously competitive.

If APS is granted its requested variance from the Commission's Rule 1606(B) and enters into a long term contract with PWCC to serve its standard offer load, its net short position will be maintained. Under the proposed agreement with APS, PWEC would contract away its generation on a long-term basis. Since its ability to sell energy at market prices would be small, it would lack market power. As is the case today, its ability to sell power to the market would be primarily during off-peak periods when competition is especially vigorous.

To the extent that the Commission's final resolution of the issues in this and related dockets frees up PWEC capacity or, more generally allows such capacity to be sold into short term markets at market rates, PWEC's share of such markets will increase. Even in this event, PWEC still will lack market power in regional power markets (e.g. the market consisting at a minimum of the Desert Southwest and Southern California). In most respects, it is this larger market that is appropriately considered in evaluating PWEC's potential market power, since power pricing reflects relatively unconstrained competition across it during most periods.

The potential market power adhering to assets located within load pockets such as Phoenix and Yuma is prospectively constrained by existing APS tariff provisions for “must run” power and will continue to be constrained by RTO tariff conditions once an RTO becomes operational.

Whenever there is a transition from traditional regulation to competitive markets, the issue arises as to whether the generation portion of the previously vertically integrated utility will have locational market power over the customers in the related control area. Pinnacle West has passed FERC’s test (the “hub and spoke” test) to determine whether it should be authorized to sell power at market rates, including the right to sell at market rates within the APS control area. Since this authority was granted, FERC has supplanted the test that Pinnacle West passed with a new and more stringent test (the “Supply Margin Assessment”). I have performed this test and find that a post-divestiture PWEC still would qualify for market rates in all areas, including the APS control area.

If the Commission still has concerns that PWEC could have locational market power in the APS control area, that concern can be addressed readily. APS’s customers are potentially subject to PWEC exercising market power only if their loads are not covered by bilateral contracts. If those loads are substantially covered by bilateral contracts – whether with PWEC (through PWCC) or some other seller – PWEC will not have market power with respect to them. Since any well-designed resolution of the issues in this docket will assure that the APS Standard Offer Service will be backed by bilateral agreements, PWEC will not have locational market power in the APS control area.

Summary of Dr. William Hieronymus Rebuttal Testimony

While a number of witnesses talk about market power, none demonstrates, or even makes a serious attempt to demonstrate, that PWEC would have unmitigated market power after transfer of the assets. Moreover, these witnesses studiously ignore the fact that the intermediate to long term contracts that are a near certain outcome of this group of proceedings will (to the extent that customers are served under contracts priced independently of future market prices) protect Standard Offer customers from the exercise of market power by PWEC or anyone else. Similarly, to the extent that a substantial proportion of PWEC's energy is sold under long-term contracts, any plausible concern that it could exercise market power with respect to any customer will be mooted.

Staff proposes a "lower of cost or market" means of pricing the wholesale component of Standard Offer service that is certain to trap costs within APS no matter what purchasing strategy it employs. If it buys from the market, including by competitive bidding for long-term contracts, it will face disallowance if the market price exceeds what would have been a cost of service price for PWEC or APS. If it buys on a cost of service-type contract, it will face disallowance if the market price is lower. This proposal would replicate, and in some respects be still worse than, some of the bad regulatory policies that led directly to the California fiasco with bankrupt and near-bankrupt utilities unable to buy power for their customers and the state having to take over procurement. Further, Staff's procedural proposals, including in particular its proposal for a smorgasbord of market power studies, inevitably and needlessly will delay Arizona moving forward along the path of restructuring that has been the Commission's firm policy for the past several years.

Summary of Cary Deise Direct Rebuttal Testimony

Without offering any actual system study or detailed analysis, Staff has taken the position that “generation and transmission in Arizona is presently inadequate to ensure reliable service to the consumers of Arizona.” At least as to APS, Staff’s conclusion is totally incorrect. APS’ transmission system and load-serving capability are adequate today, and we continue to plan prudent, timely and appropriate additions to the system.

Staff’s analysis of the role of local generation, which at times is considered “reliability must run” or “RMR” generation, is also flawed. As I discussed in my rebuttal testimony in the APS Variance Docket, local generation and transmission investments are trade-offs that largely depend on the circumstances prevailing at the time the choice of investment is made. Often, installing local generation that may operate as “must run” at limited times during the year makes more sense than siting and building a largely unused or significantly more expensive transmission line through an urban area. Additionally, local generation provides needed reliability to the local system, such as voltage support, that cannot be provided by a more remote generator, no matter how “cheap.” Staff’s must-run analysis misses many of the significant issues in this trade-off between local generation and new transmission investment. Correcting the flawed assumptions in Mr. Smith’s cost-benefit analysis shows that additional, unplanned transmission lines are not warranted at this time. Also, Staff ignores the point that merchant generators voluntarily decided to build their facilities outside the Valley; APS has not prevented any merchant plant from siting generation inside any constrained area or in agreeing to fund new transmission.

Staff’s proposal wrongly urges the Commission to require jurisdictional utilities—not SRP, the Western Area Power Administration (“WAPA”), or merchant generators—to embark on overbuilding transmission in an uneconomic, fractured, and likely futile effort to relieve all existing or potential transmission constraints in Arizona under all conceivable generation marketing patterns. This would be poor policy anywhere, but in the Desert Southwest, where load centers are both relatively

concentrated and widely separated from each other, it makes absolutely no sense. In fact, I know of no jurisdiction that has taken the position or even suggested that all transmission constraints should be remedied by constructing more transmission. Staff also vastly underestimates the costs, including economic, environmental, social and opportunity costs, associated with a policy focused on so overbuilding transmission. Further, the suggested “reliability” standards associated with this policy—standards which were unilaterally developed by Staff without a rulemaking process—are substantively deficient and far too vague to ever realistically implement.

Staff also appears to disregard, or at least marginalize, the developing institutions that are intended to facilitate system planning appropriate for a competitive market. The WestConnect RTO, the WECC, FERC and the Western Governor’s Association are all appropriately advocating or developing an integrated, regional approach to system planning recognizing the potentially different planning needs of a competitive market. Unlike Staff’s go-it-alone proposal, these institutions can embrace all affected entities, including public power, federal power marketing agencies, and merchant plants and can actually resolve issues such as cost allocation and cost-benefit trade offs.

Lastly, some intervenors have alleged that because APS or its affiliates would own both transmission and generation, there is the potential for the exercise of vertical market power. For a FERC-jurisdictional transmission owner such as APS, that is incorrect. In Orders 888 and 889, FERC required non-discriminatory access to transmission and imposed restrictions on the inappropriate sharing of information between those involved in transmission and generation. Pinnacle West and its affiliates’ FERC-mandated Standards of Conduct also would prohibit the exercise of such market power. Panda witness Roach asserts that the designation of generation as a network resource has “market power” implications for APS and its affiliates. This is simply incorrect—transmission, network transmission service and network resource designation are all related to load and are driven by load. If a generator (whether or not affiliated with APS) is serving APS’ loads, it will be

given the appropriate network designation and have the appropriate network transmission rights. However, simply calling a power plant a "network resource" will not change physical transmission limits. So, for example, all of the new capacity being constructed at Palo Verde could still not simultaneously serve all of APS' load requirements regardless of whether all were designated as "network resources" or have network transmission service.

Summary of Dr. Charles Cicchetti Rebuttal Testimony

I support competition. I continue to urge the ACC to encourage retail choice. Staff's "standard offer" or "best price" scheme is foolish. It is also dangerous and not sustainable. It would guarantee that Arizona would have its own electricity crisis. This should not and need not happen.

Staff should *not* think it can manage and direct specific "best" competitive outcomes. This is a false "god." Thus, I recommend that the Commission neither attempt to control or to regulate competitive markets nor follow Staff's draconian and misplaced advice. When left to their own devices, competitive markets will send appropriate signals to match supply and demand, obtaining the best price and one that will vary based upon the degree of risk allocation for different consumers in a competitive choice market. Attempts to micromanage competition combine the worst elements of cost of service regulation and competition and are a guaranteed recipe for a disastrous California-like result.

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