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OPEN MEETING ITEM



Arizona Electric Power Cooperative, Inc.

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July 15, 1998

Mr. Carl J. Kunasek, Commissioner
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

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AZ CORP COMMISSION
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**Re: Proposed (2nd Draft) Revisions of the Retail Electric Competition Rules
(R14-2-1601 et al) Docket No. RE-00000-C-94-0165**

Dear Mr. Kunasek:

As you are aware, AEPCO and its cooperative member-owners have fully participated in the Commission's efforts to introduce electric generation competition in Arizona. From the inception, the cooperatives have stated their belief that only the people of Arizona through a Constitutional amendment can change generation from a monopoly to competition at market based rates. That was our honest belief during the initial Rule making process and it is our honest belief today.

However, since your orders remain in full effect pending our appeal, the cooperatives have, for the past three years, been expending considerable resources, staff time, money and the work of their Boards of Directors in readying AEPCO and the electric distribution cooperatives for competition. Although we have repeatedly attempted to illustrate the fundamental differences between cooperatives and investor owned utilities, we have obviously failed. The cooperatives are different! Certain of the draft Rules currently under consideration would render futile much of our efforts to restructure to be able to function in rural Arizona and completely impair our contracts and the mortgages they support. We will briefly describe the restructuring and Rule alternatives to avoid these draconian results.

We have begun the process of restructuring AEPCO and, ultimately, with proper approvals, disaggregating it into three separate cooperative corporate entities: (i) selling and transferring AEPCO's transmission business and assets to a newly formed "Transco", Southwest Transmission Cooperative, Inc.; (ii) creating Sierra Southwest Cooperative Services, Inc. (CSP), another cooperative, to provide employees, administrative and support services to the Genco (AEPCO) and the Transco, to engage in off-system wholesale power sales, and as a certificated Electric Service Provider (ESP), to sell energy in the competitive retail electric market (either jointly with a distribution cooperative in its service area or individually as an ESP in other areas of Arizona), while (iii) leaving AEPCO a wholesale generator, selling energy at retail only through its agent, CSP.



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AEPCO and its members are developing contracts that would implement its restructuring. We have hired consultants, lawyers, appraisers, tax advisors, engineers and others who have been assisting us in the process. We have notified and have been meeting with our lenders and mortgage holders to gain their approval. The Articles of Incorporation and initial Bylaws of each corporation are in draft form and potential new directors are to begin familiarization training this month.

In a key part of this effort, AEPCO and its members sought assistance from the Arizona Legislature which, as part of H.B. 2663, amended the cooperatives' enabling statutes, Articles 2 and 4 of Title 10, A.R.S. to facilitate our contemplated restructuring. Additionally, we have joined with 450 other cooperatives nationwide in an effort to build brand loyalty through Touchstone Energy, advertising with our member distribution cooperatives in the Arizona market in contemplation of retail sales.

As well, we are at work restructuring our relationships with our members, negotiating amendments to the all requirements contracts among us which form the basis of the security for the one-quarter billion dollars in AEPCO loans made or guaranteed by the United States through the Rural Utilities Service (RUS), a federal agency charged by the Rural Electrification Act to assist rural areas, their people and economies through rural electric cooperatives. Indeed RUS has been part of these efforts at every step, suggesting, counseling and assisting. Once our restructuring efforts are complete, the entire matter will be submitted for ACC approval.

The advantages of the restructuring are multiple:

- If RUS and other lenders approve, it can mitigate the breach of the all requirements contracts and mortgage caused by the current Rules;
- Distribution cooperatives can choose a new partial or full requirements agreement;
- AEPCO's generation assets, paid for for many years by our rural owners, remain available to provide reliable, competitively priced power;
- The new CSP can search for replacement loads for those lost to competition; and
- Generation, transmission and, of course, distribution separations are established or maintained to assure compliance with FERC and other regulatory standards.

AEPCO and its distribution members have tried to work with the ACC in its Rules process. We have participated in every work group, sending key line employees on weekly six hour drives to Phoenix, absenting them from other duties. At every opportunity we have reminded you that the Cooperatives are unique. We have told you that the all requirements wholesale power contracts between AEPCO and each of its members are the financial backbone of the electric cooperative system; that they are the security for repayment of AEPCO's financing provided by the federal government and national financing markets. We have told you that federal law requires that the rates for electricity provided under these contracts must be sufficient to cover costs. We have filed every position paper, document and response requested, tying up our planning, financial and operations people. We have done and given you our best.

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As directors elected by our consumer-owners, we have made our restructuring decisions believing that the Rules adopted in December, 1996, while a "framework", could be relied upon by the us, as Affected Utilities, in our business planning. We believed the ACC did not intend to put us out of business -- primarily because to do so would leave the people of rural Arizona completely at the mercies of an untested competitive market.

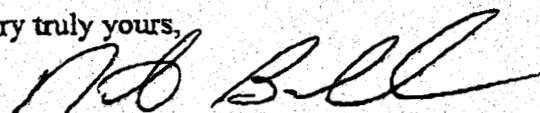
Yet, the proposed rule amendments would do just that. The Staff has asserted completely new positions, apparently drafted to head off some perceived potential wrongdoing by investor-owned, fully-integrated utilities. The proposed rules will rip away the fabric we have attempted to weave to enable us to compete. They will destroy the only financial security we have, and, if adopted by the ACC will demolish the federal system of rural electric cooperatives in Arizona by abrogating the contracts that underpin that system.

Staff's Proposed Rule R14-2-1606(B), requires rural electric distribution cooperatives to purchase power for their standard offer customers through competitive bidding, and does not allow those customers to be served by assets they have borrowed to build. R14-2-1616 and -1617 prohibit the structure we have chosen as appropriate for the already disaggregated cooperative system and by eliminating the economies of scale and other joint activities required for the cooperatives to compete effectively and survive against multi-state and multi-level holding companies who are not bound by the same rules. The affiliate structures and restrictions are especially impractical for small cooperatives. They raise costs and can render small cooperatives unable to provide competitive services -- artificially limiting the marketplace and competition.

If it is necessary to enact these Rules now - and we think it is not - then this Commission should at least follow the path taken in its earlier enacted rules on Affiliated Interests which it applied only to Class A investor-owned public service corporations (A.A.C. R14-2-801 *et seq.*) and exclude the cooperatives from the application of R14-2-1606(F) and R14-2-1616 and -1617. While that will not solve all the problems, it certainly will keep alive the possibilities we have been trying to put together the past three years.

If, however, you reject that path, the cooperatives will have no choice but to expand our present litigation, go to court and bring in the Rural Utilities Service as a party plaintiff to protect the Arizona's rural electric cooperative system and the purposes of the Rural Electrification Act.

Very truly yours,



Nick Buckelew
President, Board of Directors

c/Wally Beyer, Administrator, RUS
Sheldon Petersen, Governor, NRUCFC
All Parties of Record