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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
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IN THE MATTER OF THE COMPETITION IN)
THE PROVISION OF ELECTRIC SERVICES)
THROUGHOUT THE STATE OF ARIZONA)
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DOCKET NO. RE-00000C-94-165
**COMMENTS OF
PSEG RESOURCES INC.
ADDRESSING ISSUES
STILL IN NEED OF
RESOLUTION IN THE
ELECTRIC UTILITY
RESTRUCTURING PROCESS**

Pursuant to the Procedural Order of January 26, 1999 PSEG RESOURCES, INC.
("Resources") provides the following comments addressing issues still in need of resolution in
the electric utility restructuring process.

Summary of Comments

"Must-run" status and the provision of ancillary transmission services are critical
components of workably competitive electric power markets. Addressing the minimum capacity
needs of retail loads and assuring distribution system reliability are central components of
successful retail competition. While the rule changes presently under consideration address
these matters to a certain degree, significant work remains to be done in the area of must-run
status and ancillary transmission services. The electric utility restructuring process must begin
more clearly to address the separate competition issues inherent in the generation function, on
the one hand, and the transmission function, on the other.

Background of Lease

Resources has been granted intervenor status in this Docket.¹ Through an intermediary trust, Resources owns the three unit, 240MW (summer capacity) West Phoenix Combined Cycle Facility (the "Plant").² The Plant is presently leased to Arizona Public Service Company ("APS") through June 24, 2001. Not later than June 24, 2000 and not earlier than December 24, 1999 (about 10-1/2 months from now), APS may elect to (i) renew the lease of the Plant until June 24, 2006 at its then- fair market rental value or (ii) purchase the plant at a price equal to its then- fair market sales value. Not later than June 24, 2010, APS may elect a further five-year fair market rental renewal term (to commence June 24, 2006). APS also has a fair market value purchase option at the end of each elected renewal term. If at any point APS does not elect to exercise a then- available option to purchase the Plant or renew the lease (collectively, the "WPCC Options"),³ APS is obligated, at the direction of Resources, either to dismantle the Plant or provide Resources (or its assignee) with use of the premises on which the Plant is located and necessary ancillary rights in connection with the operation of the Plant. Both the lease arrangement and the related facilities agreement were approved by the Commission in its Opinion and Order dated June 8, 1976 in docket No. U-1345 bearing Decision No. 470401 (the "1976 Order"). The 1976 Order does not explicitly authorize APS to renew the lease or purchase the Plant upon termination of the lease.

The lease of the Plant has been in effect since June 24, 1976. In the event that APS does not properly exercise a WPCC Option to take effect on June 24, 2001 or on the last day of a permitted renewal term, the related facilities agreement will become effective. The principal

¹ Resources application for intervenor status was unopposed and was granted by the Commission July 23, 1998. Resources has also been granted intervenor status in Docket Nos. E-01345A-98-0473 (the Arizona Public Service Company stranded cost recovery proceeding) and E-01345A-97-0773 (the Arizona Public Service Company unbundled tariff proceeding) by order of the Commission dated December 7, 1998.

² The Plant does not include the two gas combustion turbines (aggregating 94 summer mW) and three moth-balled gas steam units (aggregating 96.3mW) located at the same premises as the Plant.

³ Of the numerous interests in electric generating units leased to Affected Utilities in the State of Arizona (including interests in Palo Verde Nuclear Generating Station, Unit 2 leased to APS; Irvington Unit 4 and interests in Springerville Unit 1 and Springerville common and coal handling facilities leased to Tucson Electric Power Company), the Plant is the first facility (as opposed to discrete components, such as combustion turbine generators) to reach the point where an Affected Utility must make the choice to purchase, renew the lease or return the asset. It is unclear whether or not the decision to return the Plant by failing to exercise an available option would require APS to apply to the Commission for authority to discontinue APS's serving the public from such Plant under A.A.C. R14-2-202(C).

purpose of such agreement is to enable someone *other than APS* to sell the output of the Plant to potential purchasers thereof.⁴ Among other things, APS is obligated to provide transmission services for the entire output of the Plant (up to 225mW) to any interconnection point designated by Resources (or its assignee) within a 40-mile radius of the Plant site.

Must Run Status According to APS

The metropolitan Phoenix/Valley area comprises a load pocket within which at least some local generation must operate during at least some (higher load) hours in order to meet local loads without violating system reliability criteria. This load pocket is described in two APS documents (the "APS Must-Run Analyses"): (i) "APS Must Run Generation Report" (P.K., Nov. '97), together with Appendix A entitled "APS Valley 'Must Run' Generation Analysis" (P.K., Oct. '97) and (ii) "Must Run Generation Requirements" (April 17, 1998).⁵ According to the APS Must-Run Analyses, the Plant is a "must run plant" for two reasons: first, the need to avoid exceeding the thermal limit of the 230kV transmission into the Valley during peak load periods; and second, the need to provide voltage support during such periods. APS indicates that it believes that the Plant has must-run status for approximately 400 hours a year during the June through September heavy load period.

These Comments are not the time or place to resolve APS's statements concerning the "must-run" needs of the Valley generally or the alleged must-run status of the Plant in particular. APS's statements to date would seem to reflect a restatement of economic dispatch issues peculiar to APS in a regulated, non-competitive environment rather than a broader statement concerning the absolute size of the Valley load in relation to all Valley resources (including, for example, a return of the moth-balled West Phoenix units 4, 5 and 6 to active service). A part of

⁴ Recital B of the Facilities Agreement dated as of June 1, 1976 states that:

"The principal purpose of this Agreement is to enable [the trust through which Resources owns the Plant; the "Owner Trustee"], upon termination of the Lease or any renewal thereof, to realize the residual value of the Equipment by means of a sale or lease of the Equipment to a third party unrelated to [APS]. . . Consistent with this purpose, it is the intent of the parties the Owner Trustee (together with any permitted Purchaser) to granted all such easements and other rights as may be necessary or appropriate for the operation of the Equipment and for the transmission of the electrical output of the Equipment to potential purchasers of such output, and that the provisions of this Agreement be broadly construed to give effect to this purpose and intent."

⁵ Both documents were provided by APS in its response dated ("APS Response (Third)") to the Attorney General's Third Data Request re: November 4, 1998 Settlement Agreements dated November 18, 1998, in Docket Nos. E-01345A-98-0473, E-01345-97-0773 and RE-00000C-94-165.

the electric utility restructuring process should entail the development of a rigorous means to address the Valley load during times of thermal constraint on the 230KV lines into the Valley.

Must Run/Ancillary Services According to the Rules

The proposed retail electric completion rules (the “Rules”)⁶ defines “Must-Run Generating Units” as follows:

those units that are required to run to maintain distribution system reliability and to meet load requirements in times of congestion on certain portions of the interconnected transmission grid as may be determined by the Federal Energy Regulatory Commission.

A related concept is also addressed in the Rules: Federal Energy Regulatory Commission (“FERC”) – required ancillary services.⁷ The charge for Must-Run Generation Units is to be included in electricity costs and the charge for ancillary services is to be included in delivery costs in all customer bills.⁸ FERC-required ancillary services and Must-Run Generation services are included within the scope of Non-competitive Services for purposes of the Rules.⁹ Rule 14-2-1610(I) contains the primary operative provision concerning Must-Run Generation:

The Affected Utilities and Utility Distribution Companies shall provide services from the Must-Run Generating Units to Standard Offer retail customers and competitive retail customers on a comparable, non-discriminatory basis at regulated prices. The Affected Utilities shall specify the obligations of Must-Run Generating Units in appropriate sales contracts prior to any divestiture. Under auspices of the Arizona Independent Scheduling Coordinator, the Affected Utilities and other state holders shall develop statewide protocols for pricing and availability of Must-Run Generating Units with input from other state holders. These protocols shall be presented to the [ACC] for review and filed with the [FERC] in conjunction with the Arizona Independent Schedule Administration tariff filing.

⁶ As recommended by Hearing Officer Jane L. Rodda and Teena Wolf and filed in the form of an Order on February 5, 1999. All references to ACC rules herein are to the proposed rules attached as Appendix A to the form of order.

⁷ R14-2-1601(3), 1601(39), 1606(F) and 1610(G)(3).

⁸ R14-2-1613(O).

⁹ R14-2-1601(27).

Acquisition of ancillary services is, however, made a primary duty of Scheduling Coordinators, Rule 14-2-1610(G)(3).

Ancillary Services According to the FERC

FERC requirements with respect to ancillary services are as set forth in FERC Order No. 888, as modified.¹⁰ The FERC has identified six ancillary services which must be included in any open access tariff: (1) Scheduling, System Control and Dispatch Service; (2) Reactive Supply and Voltage Control from Generation Source Service; (3) Regulation and Frequency Response Service; (4) Energy Imbalance Service; (5) Operating Reserve – Spinning Reserve Service; and (6) Operating Reserve – Supplemental Reserve Service.¹¹ In adopting FERC Order No. 888, the FERC explicitly rejected “Backup Supply” as an ancillary service:

Backup Supply Service is an alternative source of generation that a [transmission] customer can use in the event its primary generation source become unavailable for more than a few minutes. Although we believe that that the two short-term operating reserve services (spinning and supplemental) are necessary to support transmission, we conclude that long-term service is not necessary. Backup supply is a generation service that may reasonably be views as the responsibility of the transmission customer, who may contract for backup service or curtail load.

FERC Order No. 888, pp.31,710-11

Discussion

The concept of “must run” service employed in the Rules unnecessarily confuses two distinct types of generating facilities. There are “must run” facilities that fall into the “must run” category because without them the transmission system would be unreliable. There are also facilities, sometimes called “must run,” which may be called upon to operate in order to satisfy the need of the customer for reliable generation. The latter category of facilities does not fall with FERC’s definition of “must run” facilities simply because, as we have seen, FERC does not

¹⁰ Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services By Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Order No. 888, FERC Stats. & Regs. ¶31,036 (1996) (“FERC Order No. 888”); order on reh’g, Order No. 888-A, FERC Stats. & Regs. ¶31,048 (1997) (“FERC Order No. 888-A”); order on reh’g, Order No. 888-B, 81 FERC ¶51,248 (1997) (“FERC Order No. 888-B”); order on reh’g, Order No. 888-C, 82 FERC ¶61,046 (1998).

¹¹ FERC Order No. 888, p. 31,703. The FERC has determined that “Replacement Reserve Service” (defined as capacity that can be brought on line within 60 minutes), is not an ancillary service under FERC Order No. 888. AES Redondo Beach, L.L.C., et al., 83 FERC ¶61,358 (1998).

classify generation availability as an “ancillary” service which must be provided by utilities responsible for the stability and reliability of the transmission system or by the Independent System Operator, where an ISO arrangement is in place. Generation availability is the responsibility of the customer, not the operator of the transmission system, according to FERC.

It follows that the Rules should not mandate the provision of generation or backup service as one of the responsibilities of owners of must run units. Nor should the rules require that the owner of a must run unit must provide such service on a cost-of-service basis. If a competitive system of generation supply is to function efficiently and effectively, customers must learn to rely on the marketplace to fulfill their needs. A market-based system cannot work if generating facilities can be conscripted to the service of customers at lower-than-market rates merely because such customers were not prudent enough to make suitable arrangements for meeting their own needs.

APS is only the lessee of the Plant. Regardless of where the line is drawn between must run status and other incidents of standard offer retail service in Arizona, APS has power to bind only its leasehold interest in the Plant. APS is not legally entitled to commit Resources to cost-of-service regulation after the lease expires. Furthermore, Resources is not a public service corporation subject to the Commission’s regulatory jurisdiction. The Commission cannot regulate the rates for the sale of the output of the Plant at wholesale in the event Resource’s interest matures into full ownership of the facility. Under the Federal Power Act, FERC’s jurisdiction over such sales is exclusive. See Mississippi Power & Light Co. v. Mississippi, 487 U.S. 354 (1988); Nantahala Power & Light Co. v. Thornburg, 476 U.S. 953 (1986).

Under the regulatory scheme that FERC administers, if APS does not lease or own the Plant and it becomes Resources’ sole property, Resources (or its successors) will be entitled to seek authority from FERC to sell the output of the Plant at Wholesale at market-based rates. Assuming the criteria for the use of market-based rates are met,¹² all power and services from the

¹² “We generally have allowed power sales at market-based rates if the seller and its affiliates do not have, or have adequately mitigated, market power in generation and transmission and cannot erect other barriers to entry. In order to demonstrate the absence or mitigation of market power, a transmission-owning public utility must have on file with the Commission an open access transmission tariff for the provision of comparable services. The Commission also considers whether there is evidence of affiliate abuse or reciprocal dealing.” HO Energy Services (U.S.) Inc., 79 FERC ¶ 61,152 (1997), citing Progress Power Marketing Inc., 76 FERC ¶ 61, 155 at p. 61,919 (1996); Northwest Power Marketing Co., L.L.C., 75 FERC ¶ 61,281 at p. 61,889 (1996).

Plant will be provided at market-based rates.¹³

The experience of the FERC in dealing with public utility restructuring also suggests that the Commission should specifically address the role of providers of ancillary services other than those who do so under contract. It is entirely possible, for instance, for an electric utility to lack market power in the energy and capacity markets and still remain a monopoly or oligopoly supplier of one or more ancillary services.

RESPECTFULLY SUBMITTED this 23rd day of
February, 1999

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¹³ In AES Redondo Beach, L.L.C., 85 FERC ¶ 61,123 (1998), the FERC authorized market-based rates for the provision of ancillary services in the deregulated California market except where such services were to be provided under a contract specifying cost-based rates.

An original and ten copies of the foregoing filed this 22nd day of February, 1999 with:

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