

FEDERAL ENERGY REGULATORY COMMISSION
WASHINGTON, D.C. 20426

In Reply Refer To:
Office of Enforcement
Docket No. PA08-4-000
September 5, 2008

Pinnacle West Capital Corporation
Attention: Antoine Cobb
Manager – Federal Regulation
400 North 5th Street
M.S. 8995
Phoenix, Arizona 85004

Dear Mr. Cobb:

1. The Division of Audits within the Office of Enforcement (OE) of the Federal Energy Regulatory Commission (Commission) has completed an audit of Pinnacle West Capital Corporation and the following subsidiaries: Arizona Public Service Company, Pinnacle West Marketing & Trading, and APS Energy Services Company, Inc. (collectively, Pinnacle West) for the period of January 1, 2006 through June 30, 2008. The purpose of the audit was to determine whether and how Pinnacle West is complying with (1) requirements of its Market-Based Rate Authorization and (2) the Commission's Electric Quarterly Report filing requirements under 18 C.F.R. § 35.10b (2007). The Division of Audits recommends corrective actions on two findings of non-compliance. The enclosed final audit report describes our findings and recommendations.

2. On August 28, 2008, you notified us that Pinnacle West agreed with our findings and recommendations.

3. Pinnacle West should submit to OE the results of implementing the corrective actions stated herein within 30 days of the date of this letter order.

4. The Commission delegated authority to act on this matter to the Director of OE under 18 C.F.R. § 375.314 (2007). This letter order constitutes final agency action. Pinnacle West may file a request for rehearing with the Commission within 30 days of the date of this order under 18 C.F.R. § 385.713 (2007).

5. This letter order is without prejudice to the Commission's right to require hereafter any adjustments it may consider proper from additional information that may come to its attention.

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6. I appreciate the courtesies extended to the audit team. If you have any questions, please contact Mr. Bryan K. Craig, Director, Division of Audits at (202) 502-8741.

Sincerely,

Susan J. Court
Director
Office of Enforcement

Enclosure



Federal Energy Regulatory Commission

**Audit of Market-based Rate
Authorization and Electric
Quarterly Report Filing
Requirements at Pinnacle West
Capital Corporation**

Docket No. PA08-4-000
September 5, 2008

Office of Enforcement
Division of Audits

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I. Executive Summary

A. Overview

The Division of Audits within the Office of Enforcement (OE) of the Federal Energy Regulatory Commission (Commission) has completed its audit of Pinnacle West Capital Corporation (PWCC) and the following subsidiaries: Arizona Public Service Company (APS), Pinnacle West Marketing & Trading Co., LLC (PWMT), and APS Energy Services Company, Inc. (APSES). The audit evaluated compliance with (1) requirements of market-based rate authorization and (2) Electric Quarterly Report (EQR) filing requirements under 18 C.F.R. § 35.10b (2007). The audit covered the period from January 1, 2006 to June 30, 2008.

For the purposes of this audit report, PWCC, APS, PWMT, and APSES will be collectively identified as Pinnacle West. To the extent a specific entity should be identified, the report will note as such.

B. Pinnacle West Corporate Family

Pinnacle West Capital Corporation (PWCC)

PWCC, an Arizona holding company,¹ is the parent company of three energy related companies: APS, PWMT, and APSES and also controls other subsidiaries that are involved in non-energy industries including El Dorado Investment Company and Suncor Development Company. PWCC, APS, PWMT, and APSES have or did have market-based rate authorization during the audit period, and all four companies have filed an EQR during the audit period.

On September 21, 2006, PWCC and PWMT filed an application with the Commission seeking authorization for PWCC to transfer its market-based rate tariff and jurisdictional service agreements to PWMT. On January 4, 2007, the Commission issued an order permitting PWCC to transfer its market-based rate tariff and wholesale power sales agreements to PWMT.² Effective February 1, 2007, PWCC transferred its jurisdictional assets, including its market-based rate tariff, to PWMT; this resulted in PWCC no longer being classified as a public utility under the Federal Power Act.

¹ Pinnacle West Capital Corporation is a single-state holding company for which certain requirements under the Public Utility Holding Company Act of 2005 (PUHCA 2005) have been waived. *See Pinnacle West Capital Corp.*, Docket No. PH06-96-000.

² *Order Authorizing Disposition of Jurisdictional Facilities*, 118 FERC ¶ 62,002 (2007).

Arizona Public Service Company (APS)

APS was incorporated on April 29, 1886 as Phoenix Illuminating Gas and Electric Company. APS is a wholly-owned subsidiary of PWCC and a vertically-integrated public utility that serves over a million retail customers and 73 wholesale customers. APS's service territory, which includes all or portions of 11 of Arizona's 15 counties, comprises about 43,000 square miles, making it the fourth largest operating company service territory in the country. APS operates power plants with various fuel types, including coal, nuclear, natural gas/oil, and solar. APS has more than 5,000 miles of transmission lines, 26,000 miles of distribution lines, and more than 14,000 miles of underground cable.

Pinnacle West Marketing & Trading Co., LLC (PWMT)

PWMT, a wholly-owned subsidiary of PWCC, was formed on August 26, 2006. PWMT is a wholly-owned, direct subsidiary of PWCC, and was formed for the exclusive purpose of engaging in the business of marketing wholesale electric capacity and energy produced by others. PWMT does not own any generating facilities, transmission facilities, or assets or facilities that provide inputs to the electric generating process. As discussed above, the Commission authorized PWCC to transfer its market-based rate authorization to PWMT on January 4, 2007, and that transfer was effective February 1, 2007.

APS Energy Services Company, Inc. (APSES)

APSES is an Arizona corporation formed in 1998, and is a wholly-owned subsidiary of PWCC. APSES is a full-service energy services provider, engaged in a number of different ventures, including providing energy management services and the sale of retail electric energy in Western states that have adopted competitive retail open access programs.

C. Summary of Compliance Findings

Below is a summary of audit staff's compliance findings. A more detailed discussion of audit staff's findings is included in Section III. Audit staff identified two findings related to Pinnacle West's market-based rate authorization and EQR filing requirements:

- APS misidentified 11 transactions as market-based in its EQR filings when, in fact, these 11 transactions were cost-based and should have been reported as such.
- APS committed several minor reporting errors in EQRs from Quarter 1, 2006 to

Quarter 3, 2007. These errors included misidentifying affiliates and reporting incorrect contract termination dates.

D. Summary of Recommendations

Below are audit staff's recommendations to remedy the findings in this report. Detailed recommendations are included in Section III.

Audit Staff recommends Pinnacle West:

- Submit revised EQRs within 30 days of the issuance of the Final Report in this docket properly reporting these eleven transactions as being cost-based rather than market-based.
- Provide training for traders on the current market-based rate restrictions and provide training for compliance staff to improve communication with traders in making them aware of all compliance measures for market-based rate activities.
- Revise its policies and procedures to ensure that affiliates are properly identified in future EQR filings.
- Submit revised EQRs within 30 days of the issuance of the Final Report in this docket for Quarter 1, 2007, properly identifying PWMT as an affiliate of APS.
- Submit revised EQRs within 30 days of the issuance of the Final Report in this docket for Quarter 2, 2006 and Quarter 4, 2006, with the corrected termination dates.

E. Compliance and Implementation of Recommendations

Audit staff further recommends that Pinnacle West:

- Submit for audit staff's approval Pinnacle West's plans for implementing the audit staff's recommendations with respect to training, policies, and procedures within 30 days of the issuance of the Final Report in this docket.
- Submit quarterly reports to OE describing Pinnacle West's progress in completing each corrective action recommended in the Final Report in this docket. Pinnacle West should make the quarterly filings no later than 30 days after the end of each calendar quarter, beginning with the first quarter after the Final Report in this docket is issued, and continuing until Pinnacle West completes all the recommended corrective actions.

- Submit copies of Pinnacle West's written policies and procedures developed in response to the recommendations of the Final Report for audit staff's approval in the first quarterly report.

II. Introduction

A. Objectives

The objectives of the audit were to determine Pinnacle West's compliance with (1) requirements of its market-based rate authorization and (2) EQR filing requirements under 18 C.F.R. § 35.10b (2007). The audit covered the period from January 1, 2006 to June 30, 2008. Actions taken by Pinnacle West subsequent to the close of the audit period are so noted in this Final Report.

B. Scope and Methodology

To address the audit objectives, audit staff reviewed Pinnacle West's electric market-based rate sales under its market-based rate tariffs and EQR filing processes and procedures. Audit staff also conducted interviews with Pinnacle West employees, reviewed e-mails and responses to data requests, and performed selective tests on data to determine compliance with market-based rate authorization and EQR filing requirements. Audit staff conducted one site visit, several phone conferences, and also reviewed publicly available materials.

Listed below is audit work used to complete objectives for each audit scope area:

- Prior to the commencement of the audit on October 17, 2007, audit staff reviewed a large number of publicly-available materials, including, for example, Pinnacle West's EQR filings, market-based rate filings, and FERC Form No. 1. Audit staff also reviewed select filings to the Securities and Exchange Commission, such as Forms 10-Q and 10-K, as well as materials available on the company's websites including company descriptions and policies.
- Audit staff conducted a site visit to Pinnacle West's headquarters in Phoenix, Arizona to:
 1. Obtain information about the company's assets, operations, and activities in wholesale power markets.
 2. Observe the processes and procedures used by Pinnacle West to document in real-time and maintain records of wholesale power transactions.
 3. Interview company staff, particularly staff engaged in electricity trading and trading support activities.
 4. Test the controls employed by the company to ensure compliance with Commission market-based rate and EQR requirements.

- Audit staff reviewed all market-based rate transactions, as reported in the EQR from Quarter 1, 2006 to Quarter 3, 2007, to ensure compliance with all provisions and stipulations set forth by the Commission in its orders pertaining to Pinnacle West's market-based rate authorization, including the April 2006 Order³ and the August 2007 Order.⁴ Audit staff analyzed market-based rate transaction data, specifically looking at market-based rate activity in the APS control area where Pinnacle West's market-based rate authorization was revoked in the April 2006 Order, but then reinstated in the portion of the APS control area outside of the Phoenix Valley Load Pocket (Phoenix Valley) by the August 2007 Order.
- Audit staff reviewed affiliate transactions, the market-based rate tariffs governing those affiliate transactions, provisions within the Codes of Conduct for the four companies, and specific pricing provisions to ensure compliance with the Commission's affiliate restrictions.
- Audit staff held numerous discussions with Pinnacle West regulatory compliance staff and managers to discuss compliance processes and operations and preliminary observations.
- Audit staff coordinated audit field work with Commission technical and legal staff to ensure that the audit scope areas were adequately covered.
- Audit staff performed a number of specific actions to evaluate compliance with all relevant requirements of market-based rate authorization and EQR filing requirements. A summary of these actions follows.

In order to evaluate compliance with market-based rate authorization requirements, audit staff reviewed market-based rate tariffs on file, as well as filings and subsequent Commission orders, to determine the conditions and waivers that were placed on all four companies. Audit staff reviewed contract and transaction data for Pinnacle West to evaluate whether its actions were consistent with Commission requirements, principally the April 2006 Order, the August 2007 Order, and Order Nos. 2001,⁵ 652,⁶

³ *Pinnacle West Capital Corp.*, 115 FERC ¶ 61,055 (2006) (April 2006 Order).

⁴ *Pinnacle West Capital Corp.*, 120 FERC ¶ 61,153 (2007) (August 2007 Order).

⁵ *Revised Public Utility Filing Requirements*, Order No. 2001, FERC Stats. & Regs. ¶ 31,127, *reh'g denied*, Order No. 2001-A, 100 FERC ¶ 61,074, *reh'g denied*, Order No. 2001-B, 100 FERC ¶ 61,342, *order directing filing*, Order No. 2001-C, 101 FERC ¶ 61,314 (2002), *order directing filing*, Order No. 2001-D, 102 FERC ¶ 61,334 (2003) (Order No. 2001).

and 697.⁷

With respect to EQR filing requirements, audit staff reviewed all EQRs for the four companies from Quarter 1, 2006 to Quarter 3, 2007, and identified anomalous transaction and contract data in the EQRs. During the site visit, audit staff observed filing procedures and control procedures used to ensure compliance with EQR filing requirements. Audit staff met with Pinnacle West personnel who perform EQR filing procedures and regulatory compliance personnel to discuss quality controls, risk management tools, and compliance measures in place to ensure compliance with EQR filing requirements, principally the requirements articulated in Order No. 2001 and subsequent rehearing orders.

Audit staff also reviewed supporting documentation for EQR data, including contracts and invoices to ensure accuracy with the contract and transaction information reported in the EQR. Audit staff reviewed a sample of contracts and invoices to verify accurate reporting of contract data and transaction data in the EQR.

C. Market-Based Rate Authorization

Revocation and Reinstatement of Market-based Rate Authority in the APS Control Area

On August 11, 2004, Pinnacle West submitted its updated market power analysis under Docket No. ER00-2268-005, et al. pursuant to the Commission's order implementing a new generation market power analysis.⁸ On December 20, 2004, the Commission established a proceeding pursuant to section 206 of the Federal Power Act to determine whether Pinnacle West could continue to charge market-based rates in the APS, Public Service Company of New Mexico (PNM), and Tucson Electric Power Company (TEP) control areas.⁹ The Commission required Pinnacle West to submit

⁶ *Reporting Requirement for Changes in Status For Public Utilities With Market-Based Rate Authorization*, Order No. 652, FERC Stats. & Regs. ¶ 31,175, *order on reh'g*, 111 FERC ¶ 61,413 (2005).

⁷ *Market-Based Rates for Wholesale Sales Of Electric Energy, Capacity and Ancillary Services By Public Utilities*, Order No. 697, 72 Fed. Reg. 39,904 (July 20, 2007), FERC Stats. & Regs. ¶ 31,252, *clarified*, 121 FERC ¶ 61,260 (2007), *order on reh'g*, Order No. 697-A, 73 Fed. Reg. 25,832 (May 7, 2008), FERC Stats. & Regs. ¶ 31,268 (2008).

⁸ *Acadia Power Partners, LLC*, 107 FERC ¶ 61,168 (2004).

⁹ *Pinnacle West Capital Corp.*, 109 FERC ¶ 61,295 (December 2004 Order).

additional data with respect to these three control areas. In response to the December 2004 Order, Pinnacle West submitted revised wholesale market share screens, revised generation market power analyses, a revised Simultaneous Import Limit study, and a revised Delivered Price Test analysis.

The April 2006 Order revoked Pinnacle West's market-based rate authority in the APS control area. The Commission found that Pinnacle West failed to provide the necessary information about the calculation of transmission imports into the APS control area to allow the Commission to make a determination regarding Pinnacle West's market power in the APS control area. However, the Commission found that Pinnacle West passed the generation market power screens in the PNM and TEP control areas, and, therefore, Pinnacle West was allowed to charge market-based rates in those two control areas.

On May 17, 2006, in Docket No. ER00-2268-017, et al., Pinnacle West filed a Request for Rehearing and Clarification of the April 2006 Order, and on the same day submitted a compliance filing. A supplemental compliance filing was submitted on July 28, 2006 in Docket No. ER00-2268-019, et al. On December 21, 2006, the Commission provided clarification and additional details on the steps Pinnacle West could take to correct their previously submitted transmission import study.¹⁰ Pinnacle West complied with the guidance provided in this order and filed revised transmission import studies and revised Delivered Price Test analyses on February 20, 2007 in Docket No. ER00-2268-022, et al.

In the August 2007 Order, the Commission reinstated Pinnacle West's market-based rate authority in the portion of the APS control area outside the Phoenix Valley.¹¹ The Commission also found that Pinnacle West rebutted the presumption of market power in the APS portion of the Phoenix Valley in all seasons except the summer (June, July, and August). Therefore, the Commission reinstated Pinnacle West's market-based rate authority in the APS portion of the Phoenix Valley for all seasons except the summer and terminated the section 206 proceeding for the APS portion of the Phoenix Valley for those seasons. The Commission, however, affirmed its decision to revoke Pinnacle West's market-based rate authority in the APS portion of the Phoenix Valley during the

¹⁰ *Pinnacle West*, 117 FERC ¶ 61,316.

¹¹ *Pinnacle West*, 120 FERC ¶ 61,153. The Phoenix Valley is defined in a subsequent order as all delivery points at or within the Phoenix 230 kV loop, including the 230 kV substations forming the boundaries of the loop, which include: Westwing, Pinnacle Peak, Kyrene, Rudd, Knox, Browning, Goldfield, Liberty, and Rogers. *Pinnacle West Capital Corp.*, 122 FERC ¶ 61,035 at P 12 (2008) (January 2008 Order).

summer season and instituted a section 206 proceeding to determine whether Pinnacle West's market-based rate authority for the remainder of the Phoenix Valley remains just and reasonable during the summer season.

In the January 2008 Order, the Commission accepted Pinnacle West's definition of the Phoenix Valley and Pinnacle West's revised market-based rate tariffs that limit sales at market-based rates to areas outside of the APS control area, effective February 27, 2005.¹² The Commission also conditionally accepted Pinnacle West's revised market-based rate tariffs that limit Pinnacle West's sales to areas outside the Phoenix Valley during the summer season, as modified to be effective August 13, 2007. Additionally, the Commission accepted Pinnacle West's proposal to transact under the WSPP Agreement or its default cost-based rates for mitigation in the Phoenix Valley and directed Pinnacle West to make refunds for sales made in the Phoenix Valley during the summer season.¹³

On February 28, 2008, Pinnacle West filed a refund report in Docket No. ER00-2268 for sales in the Phoenix Valley during the summer season that exceeded the default cost-based caps established in this proceeding and occurred during the refund effective period beginning February 27, 2005. This refund was made in compliance with the Commission's January 2008 Order.¹⁴

On March 17, 2008, as amended April 4, 2008 and May 20, 2008, Pinnacle West submitted a compliance filing in Docket No. ER00-2268-026, et al., to comply with the Commission's January 2008 Order. As directed, Pinnacle West revised market-based rate tariffs for APS, APSES, and PWMT, as modified to be effective August 13, 2007. Pinnacle West also revised market-based rate tariffs for APS, APSES, and PWMT, effective September 18, 2007 and June 5, 2008, to comply with Order No. 697 and Order No. 697-A, respectively.¹⁵

¹² *Pinnacle West*, 122 FERC ¶ 61, 035 (January 2008 Order).

¹³ The WSPP agreement is a standardized form of agreement applicable to capacity and/or energy transactions. WSPP, Inc. administers the agreement which is available for transactions between members of WSPP.

¹⁴ *Pinnacle West*, 122 FERC ¶ 61, 035 at P 51 (2008).

¹⁵ *Market-Based Rates for Wholesale Sales Of Electric Energy, Capacity and Ancillary Services By Public Utilities*, Order No. 697, 72 Fed. Reg. 39,904 (July 20, 2007), FERC Stats. & Regs. ¶ 31,252, *clarified*, 121 FERC ¶ 61,260 (2007), *order on reh'g*, Order No. 697-A, 73 Fed. Reg. 25,832 (May 7, 2008), FERC Stats. & Regs. ¶ 31,268 (2008).

Pinnacle West submitted a revised mitigation proposal for the Phoenix Valley during the summer season to propose that Pinnacle West will make sales in the Phoenix Valley during the summer season under the cost-based APS FERC Electric Tariff Volume No. 5,¹⁶ and that sales delivered in the Phoenix Valley during the summer season under an agreement that lasts one year or longer may be made under that cost-based tariff. Pinnacle West stated that it will not seek to make sales under the WSPP Agreement in the Phoenix Valley during the summer season, but may seek to do so in the future. Finally, Pinnacle West stated that it would not make market-based rate sales in the Phoenix Valley during the summer season.

The Commission accepted these compliance filings on June 5, 2008.¹⁷

Review of Border Sales Within the APS Control Area

During the course of the audit, audit staff reviewed border sale information and market-based rate transactions for Pinnacle West. Audit staff confirmed that Order No. 697, which took effect on September 18, 2007 and allowed mitigated sellers to make market-based rate sales between a mitigated balancing authority area and a balancing authority area in which the seller has market-based rate authority under certain circumstances, was not in effect during the period in which Pinnacle West's market-based rate authority was revoked in the APS control area (April 17, 2006 to August 13, 2007). To determine whether border sales may have been an issue during the revocation period (even though Order No. 697 was not in effect), Pinnacle West performed a North American Electric Reliability Corporation (NERC) tag analysis and submitted it along with the NERC tags for verification. The analysis demonstrated that the eleven identified market-based rate transactions during the revocation period in the APS control area occurred at a border point and were either booked out or sank in a balancing authority area other than the APS control area. Additionally, Pinnacle West stated that none of these market-based rate transactions during the revocation period in the APS control area was intended to serve load in the APS control area, and no affiliate of APS sold the same power back into APS's mitigated market.

On July 3, 2008, the Commission accepted APS's revised market-based rate tariff to allow APS to make market-based rate sales at the metered boundaries of its mitigated sales area, the Phoenix Valley, and an area outside the Phoenix Valley where APS has been granted market-based rate authority for delivery during the months of June, July, or

¹⁶ See *Arizona Public Service Company*, Docket No. ER08-846-000 (May 30, 2008) (unpublished letter order), which accepted Pinnacle West's APS FERC Electric Tariff Volume No. 5.

¹⁷ *Pinnacle West Capital Corp.*, Docket No. ER00-2268-025, et al. (June 5, 2008) (unpublished letter order).

August, effective July 10, 2008.¹⁸

¹⁸ *Arizona Public Service Company*, Docket No. ER08-1104-000 (July 3, 2008) (unpublished letter order).

III. Findings and Recommendations

1. Sales Recorded as Market-Based in the APS Control Area

Pinnacle West entered into 11 transactions in the control area where the Commission revoked its market-based rate authority and entered them into its deal capture system as market-based rate sales.

Pertinent Guidance

Section 35.10b of the Commission's regulations directs each public utility to file an updated EQR covering all services it provides pursuant to Part 35, for each of the four calendar quarters of each year, prepared in conformance with the software and guidance posted on the Commission's website (<http://www.ferc.gov>).

In Order No. 2001, the Commission required that all public utilities (including power marketers) file the EQR.¹⁹ In the EQR, companies must summarize the contractual terms and conditions in all their jurisdictional service agreements (including market-based power sales, cost-based power sales, and transmission service) and provide detailed transaction information for power sales (and merchant transmission negotiated rate transactions) during the most recent calendar quarter.

The EQR Filing Requirements Guide, dated October 28, 2005 states, "All information in contracts and/or agreements pertinent to EQR fields must be reported."

Background

Audit staff identified 601 market-based rate transactions in the control area where the Commission revoked Pinnacle West's market-based rate authority (APS Control Area) during the revocation period, April 17, 2006 to August 13, 2007. Of these 601 transactions, 580 of them were permissible for several reasons:

- They were made pursuant to agreements executed prior to the revocation date of April 17, 2006, and, therefore, were authorized under the market-based rate tariff.
- They were made pursuant to agreements that received specific Commission approval.

¹⁹ Order No. 2001 at 30,116.

- They were made pursuant to agreements that were executed on the revocation date of April 17, 2006, but were executed prior to the actual time of issuance of the revocation order on April 17, 2006.

Ten of the remaining 21 transactions dealt with inter-affiliate transfers, liquidated damage adjustments, and accounting adjustments.

The remaining 11 transactions were sales in the APS control area to counterparties under the Edison Electric Institute (EEI) Master Agreement. These 11 transactions were entered into TranZ (Pinnacle West's deal capture system) as market-based rate sales. Pinnacle West determines in advance with each counterparty which agreement (EEI Master Agreement or WSPP Agreement) will be the default agreement for transactions between Pinnacle West and that counterparty. The EEI Master Agreement provides for only market-based rate sales, while the WSPP Agreement provides for either market-based rate sales or cost-based rate sales. For these 11 transactions, Pinnacle West traders transacted with counterparties whose default agreement was the EEI Master Agreement, but who were WSPP members and can therefore transact under the WSPP Agreement. The eleven transactions (shown in the table below) comprised 14 hours totaling \$232,925 and occurred within the APS control area during the revocation period.

Counterparty	Delivery Point	Quantity	Price	WSPP Cost-Based Rate Cap	Total Transaction Charge	Trade Date
PacifiCorp	Four Corners	50	\$42.00	\$59.70	\$2,100	5/4/2006
PacifiCorp	Four Corners	50	\$44.00	\$61.36	\$2,200	5/4/2006
PacifiCorp	Four Corners	50	\$45.00	\$65.11	\$2,250	5/4/2006
PacifiCorp	Four Corners	50	\$50.00	\$69.86	\$2,500	5/4/2006
UBS AG	Four Corners	200	\$29.50	\$52.32	\$5,900	5/16/2005
Morgan Stanley	Four Corners	200	\$28.50	\$52.32	\$5,700	5/16/2006
PPM Energy, Inc.	Four Corners	25	\$87.00	\$105.72	\$2,175	5/31/2006
Gila River Power, L.P.	Four Corners	800	\$49.50	\$76.07	\$39,600	8/25/2006
Gila River Power, L.P.	Four Corners	400	\$58.00	\$83.07	\$23,200	8/28/2006
PacifiCorp	Pinnacle Peak	800	\$37.50	\$95.57	\$30,000	9/21/2006
Morgan Stanley	Pinnacle Peak	2000	\$40.00	\$95.57	\$80,000	9/22/2006
PacifiCorp	Pinnacle Peak	400	\$36.00	\$95.57	\$14,400	9/22/2006
PacifiCorp	Four Corners	400	\$38.25	\$64.57	\$15,300	10/26/2006
PacifiCorp	Four Corners	200	\$38.00	\$64.57	\$7,600	10/30/2006

The price for each of the 11 transactions was below the WSPP cost-based rate cap under the WSPP Agreement. The WSPP cost-based rate cap was a form of mitigation

that was accepted by the Commission.²⁰ It is calculated using the seller's forecasted incremental cost plus an adder, which is provided for in the WSPP Agreement. All of these transactions were with WSPP members and priced below the WSPP cost-based rate caps. However, these transactions were recorded in TranZ as sales under the EEI Master Agreement and the market-based rate tariff.

The 11 transactions were entered into by six different traders. Audit staff interviewed five of the six traders involved in the 11 transactions. The sixth trader is no longer an employee of Pinnacle West.

- On May 5, 2006, Trader 1 engaged in one trade (comprising of four hours) that was recorded as market-based in the APS control area. Trader 1 acknowledged that he was aware of the market-based rate revocation through discussions at team meetings and informational documents supplied to the traders that addressed the new compliance guidelines regarding market-based rate activities in the APS control area. However, he said it was a busy day, and he cited human error as the reason why he sold in the control area to an EEI Master Agreement counterparty. Trader 1 caught his own error later that day and notified his supervisor about the trade. Trader 1 stated that there was additional training and discussions about the compliance guidelines following this transaction.
- On May 16, 2006, Trader 2 engaged in two sales in the APS control area with EEI Master Agreement counterparties. Trader 2 was notified by APS's Marketing and Trading (APSM&T) Compliance staff the next day that the trades were entered into the deal capture system as market-based rate sales. Trader 2 acknowledged that he was aware of the market-based rate revocation; however, he said that there was a short trading window and a time crunch, so he made the sales on the Intercontinental Exchange (ICE). When trading on ICE, parties are unaware of who the counterparty is until the transaction is completed, and that was why the transactions were with EEI Master Agreement counterparties. Trader 2 also stated that the sales resulted in a loss because he had to liquidate stranded positions to avoid parking energy and potentially paying a Western Electricity Coordinating Council (WECC) penalty.
- On May 31, 2006, Trader 3 engaged in one trade that was recorded as market-based in the APS control area. The trade was entered into on a Friday and the trader was notified by his supervisor on the following Monday that the sale was to

²⁰ The Commission accepted Pinnacle's use of the APS Coordination tariff and the WSPP Agreement for mitigation in the APS control area for any sales made after April 17, 2006. *Pinnacle West*, 122 FERC ¶ 61,035 at 61,160 and Note 40 (2008).

an EEI Master Agreement counterparty. Trader 3 stated that he was aware of the contract restriction prior to entering into the trade, but that he simply made a mistake. To determine the price for this type of trade, Trader 3 referred to the block pricing program (which calculates the system incremental cost) and made sure the price did not exceed the cost plus the adder. To ensure that he did not enter into this type of trade again, Trader 3 made all trades at Palo Verde unless he was certain the counterparty was a WSPP counterparty.

- On Friday, August 25, 2006, Trader 4 engaged in one trade that was recorded as market-based in the APS control area. On Monday, August 28, 2006, Trader 4 engaged in another trade that was recorded as market-based in the APS control area. Trader 4 made both trades through a broker and at the time did not know with which counterparty he was matched. Trader 4 did not record the trades in TranZ himself and he did not know it was recorded as a market-based trade until he was notified some time later. Trader 4 acknowledged that he was aware of the market-based rate revocation through verbal discussion and e-mail that addressed the new compliance guidelines regarding market-based rate activities in the APS control area. He said that he had a “long position” at Four Corners and “had no choice” but to sell. He stated that it was fast and furious, and he did not pay attention. In dealing with a voice broker, he did not know who the counterparty was for these transactions. Trader 4 was notified by APSM&T Compliance staff two days after the second trade that the trades were made with EEI Master Agreement counterparties, and thus recorded as market-based trades in the APS control area. He acknowledged that he made a mistake, but it was not intentional. Trader 4 traded for PWCC and therefore does not have access to the APS system incremental cost. Trader 4 stated that because of this, he can only sell at market. When asked how he complies with the market-based rate restriction if he can only sell at market, he stated simply that “he just doesn’t transact in the control area.”
- On Thursday, October 26, 2006, Trader 5 engaged in one trade that was recorded as market-based in the APS control area. On Monday, October 30, 2006, Trader 5 engaged in another trade that was recorded as market-based in the APS control area. The October 26 trade was entered into prior to a weekend and Trader 5 was made aware of the trade by the APSM&T Compliance Department on Monday, October 30, but not until after he entered into the second trade. Trader 5 was aware of the restriction, but was under the impression that if this type of trade was entered into it would merely result in refunds for the amount exceeding cost. Trader 5 had just transferred from trading for PWCC to trading for APS and received different training as a PWCC trader. While the Pinnacle West traders were trained to not make any trades in the control area, the APS traders were able to trade in the control area because they can view the system incremental cost that is used to enter into these transactions. Trader 5 stated that the transaction was probably recorded as a market-based rate sale because the default contract was

used when the transaction was put into the system.

As a result of the April 2006 Order, APSM&T Compliance Group instituted a daily review process to track sales executed with deliveries in the APS control area. Each of the 11 transactions was discovered by the daily review, but due to internal miscommunication, it was APSM&T Compliance Group's understanding that these sales only needed to be tracked in the event that refunds were required. Each of the traders was made aware of his transactions either by his supervisor or by APSM&T Compliance staff within days of the transaction and none of the traders entered into this type of transaction again.

In January 2007, APS's Regulatory Compliance Group learned of the 11 transactions, which prompted them to provide renewed training and modify TranZ by including a pop-up window to warn the trader if an EEI Master Agreement counterparty has been selected in the mitigated area. Additionally, each of the six traders met with the Vice President of Marketing and Trading who informed them that their bonuses were being reduced as a result of their errors and that another mistake would result in additional consequences, up to, and including termination.

Pinnacle West contacted all but one of the counterparties to ensure that the counterparty would be agreeable to having the transactions re-characterized in the EQRs as WSPP sales. None of the counterparties contacted had any objection to APS re-characterizing the transactions as WSPP sales. However, Pinnacle West did not re-file its EQRs to re-characterize these 11 transactions because of the pendency of a request for rehearing in the underlying section 206 proceeding concerning the revocation of market-based rate authority, as well as the pendency of this audit.

Audit staff concludes that the training and controls that Pinnacle West put in place as a result of the Commission revoking its market-based rate authority in the APS control area could be improved. The 11 transactions spanned a period of six months and were entered into by six different traders. While none of the traders repeated the error, audit staff believes that the frequency with which these errors occurred should have suggested that the training that was put in place was not sufficient and therefore should have prompted, at a minimum, further training for all traders. Furthermore, the internal miscommunication resulted in APSM&T's Compliance Group discovering these trades but not conveying that information promptly to APS's Regulatory Compliance Group. These two issues raise concerns that Pinnacle West did not give the Commission's revocation order enough attention and therefore did not have adequate quality controls in place to ensure compliance with the revocation order.

Recommendations

We recommend Pinnacle West:

1. Submit revised EQRs within 30 days of the issuance of the Final Report in this docket properly reporting these 11 transactions as being cost-based rather than market-based.
2. Provide training for traders on the current market-based rate restrictions and provide training for compliance staff to improve communication with traders in making them aware of all compliance measures for market-based rate activities.

2. EQR Reporting Errors

APS committed several minor reporting errors in EQRs from Quarter 1, 2006 to Quarter 3, 2007. These errors included misidentifying affiliates and reporting incorrect contract termination dates.

Pertinent Guidance

EQR Filing Requirements Guide (dated October 28, 2005), Section II – EQR Data Elements, Part 17.4 – Contract Affiliate, Part 17.4.2 states, “If the Seller and Customer are owned by the same parent company or are related in any way, the answer to the Contract Affiliate question must be Y for Yes.”

EQR Filing Requirements Guide (dated October 28, 2005), Section II – EQR Data Elements, Part 17.10 requires the filer to report the contract termination date. Specifically, Part 17.10 states, “Actual Termination Date is the date the contract actually terminates. This could be the contract termination date, or any other date the parties agree to. This date will only be filled out after the contract has been terminated.”

Background

Audit staff reviewed EQRs for the four companies for Quarter 1, 2006 to Quarter 3, 2007, and identified anomalous transaction and contract data in the EQRs. During the site visit, audit staff observed filing procedures and control procedures used to ensure compliance with EQR filing requirements. Audit staff met with Pinnacle West personnel to discuss quality controls, risk management tools, and compliance measures in place to ensure compliance with EQR filing requirements, principally the requirements articulated in Order No. 2001 and subsequent rehearing orders. Audit staff also reviewed supporting documentation for EQR data, including contracts and invoices to verify the accuracy of the contract and transaction information reported in the EQR.

Audit staff identified several minor reporting errors in EQRs from Quarter 1, 2006 to Quarter 3, 2007. These errors included misidentifying affiliates and reporting incorrect contract termination dates.

Misidentifying Affiliates

In its review of EQR data, audit staff identified several instances in which APS reported “N” (No) in the Contract Affiliate column of its Quarter 1, 2007 EQR for its contracts with PWMT. APS and PWMT are affiliates, and APS should have reported “Y” in the Contract Affiliate column for its affiliate relationship with PWMT. APS

acknowledged that the reporting of “N” in the Contract Affiliate column was a clerical error.

Reporting Incorrect Contract Termination Dates

In its review of EQR data, audit staff identified numerous instances in which APS reported a contract with a term of less than one year as Long-Term, or “LT”. Long-Term contracts are those one year or greater. A contract valid for a term of less than one year would be identified as Short-Term, or “ST.”

APS acknowledged that all four EQRs filed in 2006 initially had incorrect Termination Dates for each of the contracts identified by audit staff, which prompted the inaccurate “LT” and “ST” listings. While compiling Quarter 1, 2007 EQR data, the incorrect termination dates were discovered and corrected. In addition, APS re-filed Quarter 1, 2006 and Quarter 3, 2006 EQRs with corrected termination dates for those contracts. APS acknowledged that, due to some combination of miscommunication and oversight, EQRs for Quarter 2, 2006 and Quarter 4, 2006 were not corrected at that time.

Recommendations

We recommend Pinnacle West:

3. Submit revised EQRs within 30 days of the issuance of the Final Report in this docket for Quarter 1, 2007, properly identifying PWMT as an affiliate to APS.
4. Revise its policies and procedures to ensure that affiliates are properly identified in future EQR filings.
5. Submit revised EQRs within 30 days of the issuance of the Final Report in this docket for Quarter 2, 2006 and Quarter 4, 2006, with the corrected termination dates.



A subsidiary of Pinnacle West Capital Corporation

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August 28, 2008

Bryan K. Craig, Director
Division of Audits
Federal Energy Regulatory Commission
888 First St., N.E., RM 51-37
Washington, DC 20426

Re: Response to Draft Audit Report in Docket No. PA08-4-000

Dear Mr. Craig:

The Pinnacle West Companies¹ (identified collectively as the “Companies”) submit this letter in response to the Draft Audit Report (“Report”) forwarded by the Federal Energy Regulatory Commission’s Office of Enforcement, Division of Audits on August 14, 2008. The Report evaluated the Companies’ compliance with requirements of their market-based rate authorizations and the Electric Quarterly Report (EQR) filing requirements for the period from January 1, 2006 to June 30, 2008.

In the Report, the Division of Audits staff identified two audit findings and made five recommendations for corrective action. The Companies have reviewed the Report and agree with the Division of Audits’ findings. The Companies have already completed some of the recommended corrective actions, and will complete the remaining items promptly.

With respect to the findings, the Companies provide the following additional context and clarifications.

Sales Recorded as Market-Based in the APS Control Area: Following the revocation of market-based rate authority in the APS control area, the Companies instituted policies, training and controls with respect to the new restrictions. These actions were largely successful in ensuring compliance with the new restrictions – the six isolated incidents discussed in the Report’s findings (covering 11 trades) involved less than 0.01% of transactions that took place during the two and one-half year audit period. Moreover, once the issues regarding the 11 trades were identified, the Companies took prompt further corrective action to bolster the relevant controls.

¹ The Pinnacle West Companies include Pinnacle West Capital Corporation (PWCC), Arizona Public Service Company (APS), Pinnacle West Marketing & Trading Co., LLC, (PWMT), and APS Energy Services Company, Inc. (APSES).

Bryan K. Craig, Director
Division of Audits
Federal Energy Regulatory Commission
August 28, 2008
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As noted in the Report, the pricing of each of the trades was entirely consistent with the requirements of the WSPP tariff, which was a tariff authority available to the parties for these transactions at the time. Moreover, as the proceeding concerning the Companies' market-based rate authority was ultimately resolved on the merits (permitting market-based rate sales in all markets except for sales by the Companies in the Phoenix Valley Load Pocket during the summer months²), each of the 11 trades could be made under market-based rate authority if they were entered into now.

EQR Reporting Errors: The Companies agree that there were a limited number of clerical errors in their EQRs that were not identified and corrected in the Companies' internal review process. Note that during the audit period, the EQRs for the Companies averaged over 1,000 lines of contracts data and more than 14,000 lines of transactions data each quarter.

With respect to the first finding, a single agreement, the WSPP agreement between APS and PWMT (including two lines of data to cover market-based and cost-based sales), was incorrectly identified as a non-affiliate contract. The Companies attribute this error to a simple typographical mistake made in the initial entry of this agreement into the database. This error has been remedied.

With respect to the second finding in this category, the Companies note that the contracts that were incorrectly identified as long-term contracts were with trading partners with whom APS normally trades under long-term agreements. After expiration of long-term contracts with these trading partners, APS entered into short-term agreements while awaiting approval from FERC for long-term follow-on contracts. Again, this was an unintentional clerical error that has been remedied.

In response to the audit and consistent with our commitment to continuous improvement in our compliance program, the Companies have enhanced the reviews and controls in place to prevent such errors to the greatest extent possible.

The Companies appreciate the professionalism and courtesy of the Division of Audits staff during the audit process.

Sincerely,



Jeffrey B. Guldner
Vice President, Rates and Regulation
and Chief Compliance Officer

² *Pinnacle West Capital Corp.*, 120 FERC ¶ 61,153 (2007).