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Executive Secretary

Olme

Direct Line: (602) 542-4143

Fax: (602) 542-0765

E-mail: kmayes@cc.state.az.us

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August 4, 2005

**Re: APS Application for Surcharge; Operation of the Surcharge and Purchase Supply Adjustor; \$100 million surcharge cap. Docket No. E-01345A-05-0526**

Dear Parties to the Docket:

As you know, on July 22, 2005 Arizona Public Service filed an application with the Commission requesting recovery of \$100 million in fuel and purchased power costs, pursuant to the surcharge mechanism established in the Company's most recent rate case.

After a thorough review of the evidentiary record in this case, I have unresolved concerns with APS' interpretation of the proper operation and timing of the PSA surcharge mechanism. While I have not prejudged the Company's Application, I have a series of questions about the manner in which the Company has interpreted the PSA surcharge.

**PSA has not even been implemented; is APS' request for the surcharge premature?**

Most notably, APS is asking this Commission to approve the \$100 million through the PSA surcharge *before the PSA has even been implemented.*<sup>1</sup> This request appears to be inconsistent with my understanding of the way the PSA was to be triggered and does not appear to be supported by the testimony of several witnesses during the rate case evidentiary hearing or by comments made by the Administrative Law Judge during the Open Meeting. The Company asserts correctly that the Order directs the Company to file for approval of a surcharge after the balancing account hits \$50 million but before it reaches \$100 million. However, I would like to know whether the parties believe that the testimony and the documents in this case appear to show that the balancing account was not to be triggered before the operation of the PSA. This sets up a decision for the Commission: whether to accede to the Company's request to recover the \$100 million now, or wait until it can be discharged through the PSA, followed by recovery of any residual fuel costs through the surcharge.

**Evidentiary hearing witnesses**

In an exchange that occurred between me and Staff witness Bob Gray during the evidentiary hearing, Mr. Gray stated that it was highly unlikely that the surcharge balancing account would exceed \$50 million unless the price of natural gas climbed above \$7.60. His statement suggests

<sup>1</sup> See APS Surcharge Application, Docket No. E-01345A-05-0526.

that he believed the surcharge would not be triggered until after the PSA, because the surcharge is a balancing account to the PSA.

“A. BY MR. GRAY: Commissioner Mayes, actually if you look at the third line item in appendix C, from the bottom, it’s called, “Balance per kWh remaining outside the .004 band.” If you look at that number, that basically is a surrogate for, if you amortize the balance over one year, is what it would be per kWh.

Q. I see. Okay, thank you. So then you could take that and add it on to a bill and then figure out the total?

A. BY MR. GRAY: That’s correct.

Q. Thanks. I appreciate that. So isn’t a surcharge – this is for anybody who wants to answer, but especially Staff, RUCO, and Company – isn’t a surcharge an adjustor to an adjustor and why should we allow one at all? If the adjustor – if the bank balance gets to \$50 million, should the Company be coming in for a rate increase? And alternatively, isn’t it a sign that maybe the Company hasn’t managed its gas purchases very well?

A. BY MR. GRAY: Commissioner Mayes, a couple things. I think one thing that’s come out of running these scenarios, was that in rough terms, approximately \$100 million will be recovered within the .004 band, which is quite a bit of cost fluctuation within a year. So in looking at the scenarios we ran, *the only scenarios that show any kind of balance are scenarios that have gas costs of \$7.60 or higher*, which we believe is relatively unlikely on a cost basis.”<sup>2</sup> (italics added).

Later in this line of questioning I again asked the parties whether we should allow the surcharge after the PSA. The question was answered, and its underlying premise that the PSA would go into effect followed by the surcharge was never challenged.<sup>3</sup>

In response to several questions I posed about the Company’s estimates of fuel costs, even APS witness Steve Wheeler, Executive Vice President of Customer Service and Regulation, stated his view that the PSA would be the first adjustment made under the terms of the Settlement Agreement.

“Our concern is that if you look at the past history of APS rate cases, they have all been longer than normal for the typical utility. And you may say, well, the next one is always going to be quicker because less issues will be involved, but that hasn’t proven to be the case. And so we would hope that it would not be and shouldn’t be as long as this case took to resolve, but, nonetheless, it will take longer than we would like, and the issue is we will not be recovering a substantial body of fuel costs during that time. And that is why we would need to – and if you believe that you need to look at all of our cost elements in order to decide what to do about fuel, that obviously will complicate the case and make it longer than it otherwise would be, too.

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<sup>2</sup> See Evidentiary hearing transcript at pages 1180-1182.

<sup>3</sup> Id. at page 1182: (“Q. RUCO, could you respond to the question, why should we allow any surcharge? We’re already hypothetically under the agreement we would already be approving an adjustor. Why a surcharge on top of the adjustor?”).

And that's why our concern is we need to get in the queue as soon as possible. Because once we start off on this PSA, you know, *the first adjustment, if there is one* – and remember you control that – will barely put us up to where we were when we put these rates into effect.”<sup>4</sup> (italics added).

Here, Mr. Wheeler signals that not only is the PSA to be the first in line to be used by APS for cost recovery, but that without it – and during the time that it would take Staff to process the Company's next rate case—APS would be under-recovering fuel costs. Mr. Wheeler does not mention the surcharge.

Commission Utilities Director Ernest Johnson also telescoped his belief that the PSA was designed to recover excess fuel costs. In response to a question posed by me, Mr. Johnson stated that “there is a provision in the PSA component of the settlement agreement which identifies a what-if scenario. And under that what-if scenario, there is an opportunity for dollars in the range of \$50 million that those dollars in the range of \$50 million that those dollars will have to be addressed. Let me tell you why I think that is important.”<sup>5</sup> Mr. Johnson mentions nothing about triggering the surcharge prior to the PSA.

#### **ALJ Farmer's interpretation during Open Meeting**

During the Open Meeting discussion on the operation of the PSA, ALJ Farmer stated that based upon the adopted cap on “annual net fuel and purchased power costs,” her conclusion that the maximum amount of fuel costs that could be collected by APS annually through the PSA and surcharge is \$199 million – \$100 million through the PSA, followed by \$99 million through the surcharge.

“If you compare the costs that were incurred through base rates the year before, and to the cap, it seems to me the maximum spread of that is going to be \$200 million...if they were to reach that top the first year, and you've got the \$200 million to be put into the PSA, a 4 mil bandwidth collects, this is real big picture, but approximately \$100 million, that translates approximately into \$3 on a customer's bill. So 4 mil equals \$100 million, equals \$3. So you can put \$100 million of that, almost \$200 million through the 4 mil bandwidth, then you're left with the \$99 million which would go into the surcharge.”<sup>6</sup>

Later in her discussion, ALJ Farmer describes my amendment, which would have rejected the surcharge mechanism entirely.

“Now, given Commissioner Mayes' amendment, what that does is it takes a 4 mil bandwidth which is about \$100 million, puts it in at a \$3 charge per month for the life of the PSA, *no additional bank balances or surcharges.*”<sup>7</sup> (italics added).

ALJ's Farmer's discussion demonstrates her understanding of the PSA as the primary mechanism for APS recovery of fuel costs. Nowhere in ALJ Farmer's comments during Open

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<sup>4</sup> See Open Meeting testimony, pages 40-41.

<sup>5</sup> See Evidentiary hearing transcript, pages 383-384.

<sup>6</sup> See Special Open Meeting testimony, page 249, 251.

<sup>7</sup> Id., page 251.

Meeting did she suggest that the surcharge would be implemented prior to the PSA. In fact, she offered a directly contrary view.

### **Plain language of the Settlement Agreement**

APS's decision to file for the surcharge so quickly also appears to be inconsistent with the plain language of the Settlement Agreement, which states that the surcharge is designed to be a catch-basin for fuel charges that are not collected through the PSA.

Specifically, at Page 4, paragraph (d) of the Settlement Agreement, the adjustor and its bandwidth is defined, limiting the adjustor to \$.004 per kilowatt hour per year. The Agreement then goes on to detail the surcharge. "Any additional recoverable or refundable amounts shall be recorded in a balancing account and shall carry over to the subsequent year or years. The carry over amount shall not be subject to further sharing as described above in Paragraph 19(c) in the subsequent year or years." In the next paragraph, the Settlement Agreement outlines the procedure for APS to come in for recovery of the post-PSA surcharge amount.

Given the language of the Settlement Agreement, and the order with which the PSA and surcharge are taken in the Settlement Agreement, I would like to know whether the parties intended that the surcharge would kick in only after the PSA was operational.

### **Plain language of the Order**

In its application, APS asserts that the timing of the surcharge is driven by "the expressed desire of the Commission to address PSA cost deferrals before they hit \$100 million." Indeed, the Commission included the surcharge to address a cost deferral in the aftermath of the PSA, and we expressed our desire that the balancing account be addressed before it exceeded \$100 million. On page 18 of the Order, the Commission states that we will not allow fuel costs incurred by the Company before the effective date of the Order to be included in the PSA implemented in 2006.<sup>8</sup> This language posits a concern that the Company not be permitted to shoehorn fuel expenses generated prior to April 2005 into the 2006 PSA. The surcharge is not mentioned. The Order also sequentially describes the PSA and surcharge, suggesting the manner in which they were to operate – one after the other.<sup>9</sup>

### **Surcharges are adjustors to adjustors**

I would also like to know whether the parties believe that the institution of the surcharge in advance of the PSA is logical. Isn't the surcharge like an adjustor to an adjustor, meaning that

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<sup>8</sup> See Order, page 18, lines 1-6.

<sup>9</sup> See Order, page 17, lines 8-16. ("Therefore, we will adopt an adjustor that collects or refunds the annual fuel costs that differ from the base year level. However, we will limit the adjustor to 4 mil from the base level over the entire term of the PSA and will cap the balancing account to an aggregate amount of \$100 million. Should the Company seek to recover or refund a bank balance pursuant to Paragraph 19E of the Settlement Agreement, the timing and manner of recovery or refund of that existing bank balance will be addressed at such time. In no event shall the Company allow the bank balance to reach \$100 million prior to seeking recovery or refund. Following a proceeding to recover or refund a bank balance between \$50 million and \$100 million, the bank balance shall be reset to zero unless otherwise ordered by the Commission.")

normally a surcharge could not be implemented *before* the adjustor? For instance, Webster's dictionary defines it as "an additional tax, cost, or impost."

### **Stringent prudence review of the requested fuel costs**

The amount of the requested surcharge and its quick accumulation took me by surprise. During the evidentiary hearing, Staff testified that the balancing account would not even begin to accumulate significantly unless gas prices hit \$7.60 or higher.<sup>10</sup> Gas prices have been running at \$6.65 per MMBTU, and purchased power at \$60.01 per MWH, according to APS, and the company is predicting that it will have accumulated a \$100 million balance in August. Naturally, should the Commission decide that it is proper to consider APS' request for a 2005 surcharge, I will want to know why the Company's bank balance soared so high, so quickly. And I will want to further discuss the prudence of any actions on the part of the Company that may have contributed to the rapid accumulation of the account.

Specifically, did the Company's decision to take Palo Verde Unit 3 out of service twice for over a month during this summer force it to make market purchases that otherwise would not have been necessary during a time when Arizona's utilities saw record peak demands? The unplanned outages and their causes occurred as follows:

- May 23, 2005 - June 24, 2005 – Maintenance on reactor coolant, recirculating pump oil bearing seal and pressurizer heater replacement.
- July 6, 2005 - July 13, 2005 – Maintenance on reactor coolant and recirculating pump oil seal leak.

If these outages did in fact drive up fuel and purchased power costs that are now being sought for recovery by APS from ratepayers, and it appears that greater maintenance by the Company might or could have prevented the safety-related outages, are those costs more appropriately assessed against APS shareholders?

And did the fact that Westwing was not fully operational until the middle of July, 2005 contribute to the run-up in APS' fuel costs? If so, should APS shareholders bear this burden, rather than its ratepayers?

### **The \$100 million surcharge – hard-capped, one-time event or perpetual recovery?**

In its Application for the surcharge, the Company also expresses its view that the surcharge is to be like a glass that gets filled up, emptied by recovery from ratepayers, and then filled up again, apparently without end. I look forward to listening to the discussion on this matter when we take up the Plan of Administration put forward by the Parties. One key question for me is whether it is clear under the Order, that the surcharge was to be capped at an aggregate \$100 million – a one time opportunity for the utility to collect fuel costs above and beyond the PSA. My own

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<sup>10</sup> See APS Rate case evidentiary hearing, testimony of Bob Gray, at page 1181, in response to a question I posed. "So in looking at the scenarios we ran, the only scenarios that show any kind of a balance are scenarios that have gas costs of \$7.60 or higher, which we believe is relatively unlikely on an annual cost basis."

understanding at the time of the decision was that this was to be a one-time surcharge. In contrast, this Application appears to provide for perpetual recovery and I would like the parties to address this issue.

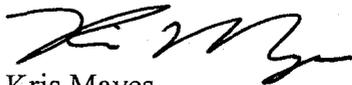
Specifically, the Order, at page 17, line 8, states, "Therefore, we will adopt an adjustor that collects and refunds the annual fuel costs that differ from the base year level. However, we will limit the adjustor to 4 mil from the base level over the entire term of the PSA *and will cap the balancing account to an aggregate amount of \$100 million.* . . . Following a proceeding to recover or refund a bank balance between \$50 million and \$100 million, the bank balance shall *be reset to zero* unless otherwise ordered by the Commission." (italics added).

The apparent failure of APS to reconcile the evidentiary proceedings with its Application is disappointing. As a Commissioner, I placed a high value on the testimony and comments offered during the rate case evidentiary hearing as well as the Open Meeting. I viewed the hearing as perhaps the only real opportunity to ascertain the Parties' understanding of the Agreement, which was hammered out entirely behind the scenes, and to thoroughly analyze its meaning prior to casting a vote. The answers I received, some of which are cited in this letter, served as the basis for my decision and ultimately my confidence that APS would not misinterpret the adjustor mechanisms we were handing them for the first time. I am concerned that by this Application, APS is seeking to maximize the surcharge and hasten its implementation.

I would like APS and the other signatories to the Settlement to demonstrate how the rate case evidentiary record supports the Application by APS. Perhaps APS should consider withdrawing its request until it can provide appropriate evidentiary support for its Application. Alternatively, the Company could re-file its request after the PSA has been implemented and has had an opportunity to do what it was apparently designed to do – help APS recover the cost of natural gas consumed in the production of electricity and purchased power, beginning after April 2006. I also would like the Parties to the Settlement, but particularly Staff, APS and RUCO, to respond to the questions I have posed in this letter.

Thank you for your attention to these important matters. Your responses to my questions and concerns will aid me in my consideration of this Application.

Sincerely,



Kris Mayes  
Commissioner

Cc: Chairman Jeff Hatch-Miller  
Commissioner Marc Spitzer  
Commissioner William Mundell  
Commissioner Mike Gleason  
Ernest Johnson  
Stephen Ahearn