

ORIGINAL



0000028466



PINNACLE WEST
CAPITAL CORPORATION
LAW DEPARTMENT

RECEIVED

06

2005 SEP 19 P 5:00

AZ CORP COMMISSION
DOCUMENT CONTROL

Thomas L. Mumaw
Senior Attorney
(602) 250-2052
Direct Line

September 19, 2005

Commissioner Kristin K. Mayes
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007-2996

Re: APS Application for Surcharge; Operation of the Surcharge and
Purchase Supply Adjustor: \$100 Million Surcharge Cap;
Docket No. E-01345A-05-0526 and E-01345A-03-0437

Dear Commissioner Mayes:

Arizona Public Service Company ("APS" or "Company") is hereby responding to the matters raised in your letter of August 25, 2005. As before, APS will address the issues raised by your August 25th letter in the order presented.

ISSUE NO. 1: "Prudence of expense related to Palo Verde Nuclear Generating Station ('PVNGS') outages and the fairness of assessing them against ratepayers"

Utilizing the same procedure as in our response to Commissioner Gleason's letter, APS is providing Commission Staff on a confidential basis the requested daily breakdown of the additional costs of unanticipated performance from Palo Verde generation for the periods identified in June and July of 2005. Under provisions of the Protective Agreement between APS and Staff, Staff can share this information with you and the other Commissioners on the same confidential basis. These incremental costs reflect both the actual performance of the PVNGS units and the performance of these units as reflected in the base fuel cost allowed by the Commission in Decision No. 67744 (April 7, 2005) during the period beginning April 1, 2005. This total of just under \$18.6 million is reflected in the amount of PSA deferrals through the end of August 2005, which serves as the basis for the Company's requested PSA surcharge.

APS has also determined the incremental costs of the August outages using the same methodology. They are approximately \$11.9 million for the entire month but APS has yet to develop a daily breakdown of such costs. This data is also being provided Commission Staff. But because the Company's surcharge request utilized anticipated rather than actual PVNGS performance for August 2005 in its PSA surcharge request Application, these August 2005 outages at PVNGS has no impact on the requested surcharge amount.

It is not just a Company assertion that forced outages are an expected aspect of power generation, it is an incontrovertible fact. That being said, APS certainly agrees that the Commission can review the prudence of our overall generation operations. As to the timing of that review, APS neither stated nor implied that the prudence of the PVNGS outages in May/June and July could not be examined by the Commission prior to November 1, 2005 (the requested date for the 2.1% PSA surcharge) – only that it need not do so. In part, this is because: (1) APS will not have recovered any portion of the \$100 million attributable to generating plant performance until close to the end of the two year amortization period; (2) at present, the Company's unrecovered fuel and purchased power costs in excess of the \$100 million request already exceed the incremental fuel and purchased power costs attributable to power plant performance; (3) the Company has already absorbed unrecovered fuel and purchased power costs through the operation of the 90/10 sharing mechanism that represent a significant portion of the impact of Palo Verde generating plant performance; and (4) surcharge requests are not customarily the forum for resolving prudence issues, as is discussed below.

APS' reference in its earlier response to a prudence review in a general rate case was referring to this Commission's own determination to review the prudence of Southwest Gas Corporation's ("Southwest") gas hedging and procurement policies in Southwest's general rate case and not in that utility's repeated purchased gas adjustment ("PGA") proceedings. Indeed, APS is not aware of any gas utility surcharge request that underwent a prudence review prior to its implementation. This procedure is also consistent with the statements of both Commission Staff and the Residential Utility Consumer Office at the Procedural Conference of September 12, 2005.

Your letter asserts that the prudence presumption reflected in Commission rule was enacted prior to the era of adjustment mechanisms. This is factually incorrect. Rule R14-2-103 ("Rule 103") was first enacted in 1982 and has been retained through several rulemakings amending Rule 103, the most recent of which was in 1992. With the exception of a one month hiatus in January 1979, APS had a fuel adjustment mechanism in place from 1952 until its abolition in Decision No. 56450 (April 13, 1989). Tucson Electric Power (then Tucson Gas & Electric) has had an adjustor for gas fuel costs as far back as 1941.

Moreover, the language in the rule merely codified the holding of the United States Supreme Court in *State of Missouri ex rel. Southwestern Bell Telephone Company v. Public Service Commission of Missouri*, 262 U.S. 276 (1923) (the "Southwest Bell"). In *Southwest Bell*, Justice McReynolds, writing for the majority, stated:

[6] [7] The important item of expense disallowed by the commission-\$174,048.60-is 55 per cent. of the 4 1/2 per cent. of gross revenues paid by plaintiff in error to the American Telephone & Telegraph Company as rents ****547** for receivers, transmitters, induction coils, etc., and for licenses and services under the customary form of contract between the latter company and its subsidiaries. Four and one-half per cent. is the ordinary charge paid voluntarily by local companies of the general system. There is nothing to indicate bad faith. So far as appears, plaintiff in error's board of directors has exercised a proper discretion about this matter ***289** requiring business judgment. It must never be forgotten that, while the state may regulate with a view to enforcing reasonable rates and charges, it is not the owner of the property of public utility companies, and is not clothed with the general power of management incident to ownership. The applicable general rule is well expressed in *States Public Utilities Commission ex rel. Springfield v. Springfield Gas & Electric Co.*, 291 Ill. 209, 234, 125 N.E. 891, 901:

'The commission is not the financial manager of the corporation, and it is not empowered to substitute its judgment for that of the directors of the corporation; nor can it ignore items charged by the utility as operating expenses, unless there is an abuse of discretion in that regard by the corporate officers.' [Emphasis supplied.]

Although concurring in the judgment to reverse the order of the Missouri Public Service Commission, Justices Brandeis and Holmes disagreed with the "fair value" discussion in the majority's opinion. They did not disagree, however, on the presumption of managerial prudence:

The term 'prudent investment' is not used in a critical sense. There should not be excluded, from the finding of the base, investments which, under ordinary circumstances, would be deemed reasonable. The term is applied for the purpose of excluding what might be found to be dishonest or obviously wasteful or imprudent expenditures. Every investment may be assumed to have been made in the exercise of reasonable judgment, unless the contrary is shown. [Emphasis supplied.]

Suffice it to say, the presumption of prudence is an accepted part of American regulation of public utilities, with or without the existence of adjustor mechanisms.

APS also fundamentally disagrees that an adjustor imposes upon customers any "burden" that is either unfair or not otherwise appropriate. APS is obliged by law to provide service upon request and on demand to all who request it within its designated service area. Its allowed return is constrained to the cost of capital, without the additional profit opportunities enjoyed by unregulated enterprises, which can enter and exit markets and unilaterally change prices to maximize profitability. Correspondingly, APS is entitled to recover the prudent costs of providing that service. Nothing less is either fair or lawful. The question is one of when and how. APS can seek recovery in large increments through continuous general rate cases, along with the higher capital costs as the utility's financial integrity is eroded by the regulatory lag inherent in general case rate proceedings. Or APS can seek recovery in smaller increments (without the additional burden of higher capital costs) through an effective rate adjustment mechanism.

Amounts later found to have been improperly collected through an adjustment mechanism, whether the PSA, a PGA or some other mechanism, are routinely refunded or credited through the same mechanism. In fact, APS is aware of no other method that has been utilized in or out of Arizona.

Finally, Staff has suggested, and APS along with RUCO have supported, a proposal to put the prudence issue aside by virtue of a pleading filed September 14, 2005. Therein, APS agreed to remove from consideration in this proceeding some \$20 million – significantly more than the deferred fuel and purchased power costs attributable to Palo Verde performance and included in the original PSA surcharge request – in exchange for a timely hearing on the balance of its PSA surcharge request. This removal was expressly without prejudice, and thus such removal is in no way an admission that any portion of the Palo Verde outage-related costs was imprudent. The \$20 million remains deferred in the PSA bank balance. APS will pursue full recovery of this \$20 million in whatever future Commission proceeding they are again placed at issue.

ISSUE NO. 2: "APS response to the evidentiary record and Open Meeting record"

APS has never maintained that it could seek a surcharge prior to the PSA becoming effective. The record is clear on this point, that the PSA, including the Annual PSA Adjustment Factor, became effective April 1, 2005, with an Annual PSA Adjustment Factor of zero. That is what is indicated by Decision No. 67744. That is what was, at this Commission's order and after Staff review, noticed to APS customers immediately following Decision No. 67744. That is what is shown on APS bills today. See sample APS bill attached as Exhibit A.

An adjustment factor of zero is not an unusual circumstance and, indeed, the Annual PSA Adjustment Factor, or for that matter the equivalent concept with regard to a PGA, will routinely be reset to zero following a general rate case. Thus the issue, as framed in my earlier response, was whether any witness indicated that a PSA surcharge request could come before the first resetting of the Annual PSA Adjustment Factor in April 2006. On that point, the testimony of Mr. Wheeler, quoted in my earlier response, is unmistakably a "yes." The amendment requiring a PSA surcharge request prior to the PSA bank balance reaching \$100 million did not affect either the effective date of the PSA mechanism or the ability of APS to seek a PSA surcharge prior to April 2006. What it did do was to remove the discretion APS would have had absent such amendment not to seek a PSA surcharge – a fact cited by at least one Commissioner as a reason for his support of the amendment.

ISSUE NO. 3: "Surcharges are adjustors to adjustors"

The Company's earlier letter tried to explain that the Annual PSA Adjustment Factor and a PSA surcharge are two separate and distinct aspects of the PSA mechanism approved in Decision No. 67744, having separate and distinct functions in the recovery of prudent fuel and purchased power costs in excess of the Base Fuel Cost. Your letter does not seem to take issue with this and neither did any of the parties to the Company's last general rate proceeding. Rather you return to the issue of whether a surcharge can precede the effectiveness of the PSA and the implementation of the Annual PSA Adjustment Factor – an issue upon which we are in agreement given the fact that the PSA and the Annual PSA adjustment Factor were approved by the Commission effective April 1, 2005.

ISSUE NO. 4: "100 million surcharge – hard capped, one time event or perpetual recovery"

The Company is not sure what it can add to its previous discussion of this issue. The Company's originally proposed PSA Plan of Administration clearly indicated that PSA deferrals can exceed \$100 million if an appropriate PSA surcharge request has been made and that multiple requests for a PSA surcharge can be made if the prerequisite for such a request (PSA bank balance hits \$50 million) is met on multiple occasions. It was circulated to all parties to the settlement.¹ None disagreed with APS on this latter point. As to the former, Staff did initially have a question concerning the ability of APS to defer amounts in excess of \$100 million during the period between the filing of a PSA surcharge request and Commission action on such request. In relevant part, the joint PSA Plan of Administration filed by all the settlement parties on June 6, 2005 reflects that singular concern. And although Staff's recommendation on the PSA

¹ Those few parties to the Company's last rate proceeding that did not join into the settlement did not take a position on the PSA.

Plan of Administration resolves that concern in a reasonable manner, this initial concern by one party to the settlement did not suggest that a PSA surcharge would be limited to a single request not to exceed \$100 million.

ISSUE NO. 5: "Interpretation of the starting time of the PSA"

As noted above, APS finds no need for interpretation here. Decision No. 67744 clearly approved new rates for the Company, including the PSA mechanism, effective April 1, 2005. That is what is stated on the Company's effective rate schedule PSA-1. That is what was stated in the Staff supervised notice to APS customers and in the customer education program both required by Decision No. 67744 and reviewed by Staff.

The PSA Plan of Administration sets forth the process for determining any change in the existing PSA Adjustment factor. Specifically, the preceding calendar year (or in the case of the April 2006 PSA Adjustment Factor, the last eight months of 2005) fuel and purchased power costs are divided by kWh sales for the same period to develop a cents per kWh cost. The difference between that per kWh cost and the base fuel cost of \$.020743 becomes the PSA Adjustment Factor, subject to a four mill cap.

WESTWING UPDATE

In my prior letter, I indicated that the situation of reduced capacity at Westwing from the July 2004 fire did not cause APS to experience any transmission restrictions. Although that statement was correct, APS did experience a further reduction in capacity at Westwing during the installation of the new transformers. This occurred on May 25, May 30 through June 2, and finally on July 6, 2005. This required APS to run Ocotillo and West Phoenix out of merit order with an incremental cost of \$138,500 for the six days combined. I hope this additional information is helpful in understanding all the ramifications of Westwing relative to the Company's pending request for a PSA surcharge.

Sincerely,



Thomas L. Mumaw
Attorney for Arizona Public Service Company

TLM/
Enclosures

Commissioner Kristin K. Mayes

September 19, 2005

Page 7

cc: Chairman Jeff Hatch-Miller
Commissioner Mike Gleason
Commissioner William Mundell
Commissioner Marc Spitzer
Parties to the Docket

Your electricity bill
August 17, 2005

Your account number

Your service plan: Time Advantage Rate

Meter number:
Meter reading cycle 11

Charges for electricity services

Amount of electricity you used

Cost of electricity you used

Basic service charge	\$6.54
Delivery service charge	\$36.96
Environmental benefits surcharge	\$0.35
Competition rules compliance charge	\$0.60
System benefits charge	\$3.76
Power supply adjustment	\$0.00
Metering*	\$5.12
Meter reading*	\$1.71
Billing*	\$1.92
Generation of electricity on-peak*	\$73.90
Generation of electricity off-peak*	\$16.12
Transmission and ancillary services*	\$8.40
Cost of electricity you used	\$155.38

Meter reading on Aug 15	19499
Meter reading on Jul 15	17734
Total electricity you used, in kWh	1765

On-peak meter reading on Aug 15	7448
On-peak meter reading on Jul 15	6746

On-peak electricity you used, in kWh 702
(9 am to 9 pm Monday to Friday)

Off-peak electricity you used, in kWh 1063
(9 pm to 9 am weekdays and all day Saturday and Sunday)

Taxes and fees

Regulatory assessment	\$0.36
State sales tax	\$8.72
County sales tax	\$1.09
City sales tax	\$4.67
Franchise fee	\$0.00
Cost of electricity with taxes and fees	\$170.22

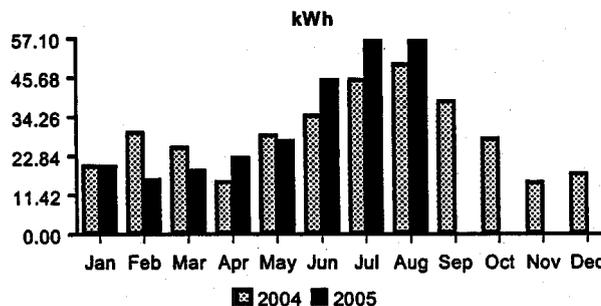
Comparing your monthly use

	This month	Last month	This month last year
Billing days	31	31	29
Average outdoor temperature	94°	94°	96°
Your total use in kWh	1765	1769	1451
Percentage of on-peak use	40%	45%	41%
Your average daily cost	\$5.49	\$5.80	\$4.72

Total charges for electricity services \$170.22

* These services are currently provided by APS but may be provided by a competitive supplier.

Average daily electricity use per month



Record heat could cause higher bills this summer. This past July was the third hottest July on record. For tips on how you can save energy, visit aps.com.

X