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ORIGINAL



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BEFORE THE ARIZONA CORPORATION COMMISSION

05

Jeff Hatch-Miller
Chairman
William A. Mundell
Commissioner
Marc Spitzer
Commissioner
Mike Gleason
Commissioner
Kristin Mayes
Commissioner

2005 NOV 16 P 2: 05
AZ CORP COMMISSION
DOCUMENT CONTROL

IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE COMPANY
FOR A HEARING TO DETERMINE THE
FAIR VALUE OF THE UTILITY PROPERTY
OF THE COMPANY FOR RATEMAKING
PURPOSES, TO FIX A JUST AND
REASONABLE RATE OF RETURN
THEREON, TO APPROVE RATE
SCHEDULES DESIGNED TO DEVELOP
SUCH RETURN, AND FOR APPROVAL OF A
PURCHASED POWER CONTRACT.

Docket No
E-01345A-03-0437

IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE COMPANY
FOR APPROVAL OF A POWER SUPPLY
ADJUSTOR SURCHARGE.

Docket No
E-01345A-05-0526

AUIA'S POST-HEARING BRIEF

Pursuant to the instructions of the Chief Administrative Law
Judge at the close of hearing, the ARIZONA UTILITY INVESTORS
ASSOCIATION (AUIA) hereby submits its post-hearing brief in the
above-captioned matter.

INTRODUCTION

The evidence in this proceeding is clear that Arizona Public
Service Co. (APS) has experienced an explosive run-up in fuel and
purchased power costs -- led by swollen natural gas prices -- beyond
the cost of fuel established in its last rate case.

There is no doubt that APS has incurred the costs that are
covered by the surcharge application. Based on the Commission's
decision in creating the Power Supply Adjustor (PSA) and on

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1 universally accepted ratemaking principles, there is also no question that APS has
2 the right to recover all of its prudently incurred costs from ratepayers.

3 Unfortunately for everyone involved, this is a case of, "Pay now, or pay
4 later." So, the Commission's decision in this proceeding is all about timing.

5 If the Commission acts resolutely and imposes the surcharge now, it will
6 soften the blow to consumers. But, if the Commission delays imposing the
7 surcharge until next spring, it will increase the billing impact on customers at the
8 worst time of the year and also risk adverse reactions from the financial community
9 that could further harm the company and its customers.

10 UNDERLYING ISSUES

11 An underlying timing issue is the question of whether it was appropriate for
12 APS to file a surcharge request ahead of the first adjustment to the PSA, which
13 would normally occur in April 2006. The issue was raised by Commissioner Mayes
14 in a letter to the docket¹ and in her examination of some witnesses.

15 This question is difficult to fathom for several reasons and none of the
16 witnesses for the settling parties concurred with her concern.

17 The Commission's order in Decision No. 67744 clearly requires APS to notify
18 the Commission if its bank balance reaches (plus or minus) \$50 million and it
19 requires APS to seek recovery or a refund before the bank balance reaches \$100
20 million.²

21 Neither the Commission's order nor the proposed Plan of Administration
22 (PA) endorsed by the settling parties imposes any timing restrictions on a surcharge
23 application.³ In fact, the PA clearly describes how an extant surcharge is to be
24 accounted for in calculating a PSA adjustment.⁴

25 As the company's policy witness, Steve Wheeler, testified, it would make no
26 sense for the Commission to include a surcharge provision and a specific filing
27 requirement if there were no likelihood that the Application would be acted upon
28 promptly. Clearly, the surcharge provisions are designed to precipitate Commission

¹ See Mayes Letter dated August 4, 2005

² See Decision No. 67744 @17; see Keene Direct @ 3

³ See Keene Direct @5, Para. 7 & Keene Direct @ 7

⁴ See Keene Direct @ 6, Para. 13, 16

1 action before the burden becomes too large for consumers to bear and before the
2 company's credit becomes stressed.⁵

3 Another set of concerns raised before and during the hearing related to the
4 use of certain terms and definitions in the Plan of Administration (PA) and whether
5 the PA accurately reflected the provisions of the settlement agreement, as amended
6 in Decision No. 67744. For Example, Commissioner Gleason focused on the
7 application of such terms as "bank balance," "balancing account," "PSA adjustor"
8 and "PSA surcharge" in describing how the PSA is tracked and calculated.⁶

9 At hearing, Staff witness Barbara Keene stood resolutely by the definitions
10 that were agreed to by the settling parties and the way they are applied in
11 calculating and administering the PSA, in furtherance of Decision No. 67744.⁷

12 AUIA can only respond to these issues as semantic anomalies and we suggest
13 that a reasonable man hypothesis should apply in interpreting the Plan of
14 Administration. Witnesses for the settling parties expressed identical
15 understandings of a) the terms used in the PA, b) the calculation and administration
16 of the PSA and c) the causal relationship between the PA and Decision No. 67744.⁸

17 In the face of such unanimity, it is reasonable to conclude that the
18 interpretation offered by the settling parties is accurate and appropriate and the
19 Commission should adopt that conclusion.

20 **NOW OR LATER**

21 The evidence in this case demonstrates conclusively that any significant delay
22 in applying the surcharge will add to consumer discomfort in several respects.

23 The first is **rate shock**. Company witness Peter Ewen testified that APS'
24 actual deferrals reached \$115 million at the end of August and will reach \$143
25 million by the end of this year, excluding the 10% sharing with ratepayers.⁹

26 The \$80 million recovery over a 24-month period results in a surcharge of
27 .1416 cents per kWh. If it is applied now, Mr. Ewen's projections show that the first

⁵ See Transcript @ 379-80

⁶ See Keene Direct @ 5, PA @ 4 & Gleason Letter dated August 30, 2005

⁷ See Generally, Transcript @ 260-291

⁸ For example, see RUCO Exhibit 1 @ 2

⁹ See Ewen Direct @ 5

1 PSA adjustment next April would be only about 3 mills and a second surcharge
2 application would probably not occur until late in 2006.¹⁰

3 On the other hand, if the surcharge is delayed, the first PSA adjustment
4 would use up the entire 4-mill bandwidth and a surcharge of more than \$100 million
5 would come into play soon thereafter.¹¹ The net result of this scenario is that
6 customers would be hit with higher-than-necessary increases just in time for the
7 annual summer rate change and the high use air conditioning season.¹²

8 In pre-filed testimony, Staff witness William Gehlen argued that rejecting or
9 delaying the Company's application will not result in any long-term benefit for
10 customers and that denying or deferring the current request "will result in future
11 surcharge requests of even greater magnitude."¹³

12 The Staff's late-filed exhibit demonstrates similar results. The exhibit posits
13 two scenarios, pay-now and pay-later. The first scenario assumes that the \$80
14 million surcharge is imposed in January, plus a new adjustor rate of 3 mills in April,
15 which would collect about \$85 million in 12 months, and finally, a \$60 million
16 surcharge in October 2006.

17 The second scenario assumes no surcharge before April, a new 4-mill adjustor
18 rate in April expected to collect \$112 million in 12 months, and a \$130 million
19 surcharge in September 2006.¹⁴

20 Combined with the impact of the last rate case, the pay-now scenario
21 produces a 9.65 % summer increase for an average use customer and a 7.99 % winter
22 increase. The pay-later scenario produces a 10.37% summer increase and an 8.86 %
23 winter increase.¹⁵

24 In fact, AUIA believes that the pay-later effects are under-stated, but it is
25 obvious that a delay in implementing the pending surcharge produces no long-term
26 benefits for consumers and adds an increment of rate shock next summer.

27 But there is more. Ms. Keene, Mr. Gehlen and RUCO witness Mary Lee Diaz
28 Cortez all noted that any delay in amortizing fuel cost deferrals, adds **interest** to the

¹⁰ See Ewen Direct @ 2

¹¹ See Ewen Direct @ 6, see Transcript @

¹² See Transcript @ 354, 386-87

¹³ See Gehlen Direct @ 11

¹⁴ See staff Exhibit 6

¹⁵ Ibid

1 bank balance that must be applied eventually to customer bills.¹⁶ Accumulated
2 interest had reached nearly \$309,000 in August based on only five months of PSA
3 operation.¹⁷

4 Finally, delaying the pending surcharge introduces an element of **financial**
5 **risk** for the company and its ratepayers that is akin to shooting craps.

6 Mr. Wheeler testified that the credit rating agencies and financial analysts are
7 watching this proceeding to determine whether the PSA mechanism approved by
8 the Commission will really work to protect the company's cash flow and credit
9 metrics.¹⁸ He noted that Standard & Poor's has stated that the PSA mechanism is
10 "relatively weak" and that APS' continued credit rating depends on a speedy and
11 positive resolution of the surcharge application.¹⁹

12 Mr. Wheeler also agreed with the assessment that if the Commission declined
13 to approve the surcharge, it would signal to the financial markets that the PSA has
14 failed its first significant test.²⁰

15 Whether a delay in imposing the surcharge could result in downgrading APS'
16 credit rating is anybody's guess. But why take the risk? The consequences of a
17 downgrade on the company and its customers would be catastrophic and the
18 company's right to recover its costs is immutable.

19 **THIS CASE IS NOT ABOUT...**

20 Three issues consumed a fair amount of hearing time that have no bearing
21 whatsoever on the decision in this proceeding. They are:

22 **The hard cap.** Is the PSA governed by a hard cap of \$776 million on the total
23 fuel and purchased power costs that APS can use to calculate its deferred costs? The
24 answer is yes, and no one has denied it.

25 Mr. Ewen has confirmed it.²¹ Ms. Keene and Ms. Diaz Cortez confirmed it.²²
26 The proposed Plan of Administration specifies the existence of a hard cap.²³

¹⁶ See Keene Direct @ 15; see Gehlen direct @ 11; see Transcript @ 158

¹⁷ See Ewen Direct, Sched. PME2

¹⁸ See Wheeler Direct @ 9, 11; see Transcript @ 355

¹⁹ See APS Exhibit 3 @ 1 & 2; see Transcript @ 356-57

²⁰ See Wheeler Direct @ 4; see Transcript @ 355

²¹ See Transcript @ 613

²² See Keene Direct @ 12-13; see Transcript @ 224 & 245

²³ See PA @ 6, Para. 3

1 Mr. Ewen conceded under cross-examination that his deferral projections in
2 late 2006 anticipate that the cap will be lifted or altered,²⁴ but those projections were
3 only offered to provide the Commission with some long-range context on which to
4 base this decision.

5 From the company's perspective and that of the rating agencies, the existence
6 of the cap does not alter the amount of unrecovered fuel expense APS will have
7 incurred by the end of 2006. Disguising that reality through the application of the
8 cap would be frowned on by the financial community. The projections also have no
9 bearing on the pending application for a surcharge, which will not bring the
10 company close to exceeding the expense cap.

11 Since the end of the hearing, APS has filed a new general rate case, which
12 requests that the hard cap be removed or increased. The rate case is the appropriate
13 place to address the continuation of the expense cap.

14 **Prudence.** No party has raised questions about the prudence of the
15 company's gas purchases covered by the amended application.

16 The company's original surcharge application included some amount of
17 expense involved in the cost of replacement power incurred during the unplanned
18 outages at the Palo Verde Nuclear Generating Station, but APS agreed with Staff
19 and RUCO to remove \$20 of million of fuel and purchased power cost that might be
20 attributable to those outages.²⁵

21 Mr. Wheeler indicated that the company chose that course in order to
22 expedite this proceeding, but that APS intends to pursue recovery of those expenses
23 in another proceeding.²⁶ Clearly, the Commission can explore prudence in a
24 subsequent proceeding, but there are no relevant prudence issues attendant to the
25 decision in this case.

26 **Benchmarking.** In his pre-filed testimony, Mr. Carlson asserted that, from
27 April through August 2005, APS' hedging program has saved ratepayers more than
28 \$30 million over current forward prices. Commissioner Mayes responded with
29 questions about whether the hedging program has been audited and whether it
30 should include a benchmarking requirement.

²⁴ See Transcript @ 599

²⁵ See Wheeler Direct @ 3,7

²⁶ Ibid, see Transcript @ 395-96

1 Mr. Gehlen testified that while APS' gas procurement program had not been
2 audited, the application was reviewed for reasonableness, comparing fuel and
3 purchased power costs against known market information.²⁷ He also testified that
4 APS' hedging strategy has worked effectively.²⁸

5 Mr. Carlson testified that APS would be willing to participate in a
6 benchmarking program, although he expressed some skepticism about its potential
7 value because fuel-purchasing information tends to be highly confidential.²⁹

8 In any case, benchmarking or some other test of APS' hedging practices is not
9 relevant to this proceeding. Neither the Commission's rules nor Decision No. 67744
10 require benchmarking or any other test of hedging practices. In fact, it is worth
11 noting that, despite a previous workshop recommendation, this Commission has
12 never adopted a policy in support of or even condoning hedging.

13 Certainly, the Commission can consider proposals to test hedging practices in
14 the context of a rate case or any extension of the PSA.

15 **THE RIGHT TO RECOVER**

16 Some of the discussion surrounding the \$776 million expense cap was
17 troubling to AUIA. There was an implication that the hard cap could be construed
18 to limit the costs that the company can recover. AUIA is constrained to point out
19 that the PSA cannot be used to prevent the company from recovering its legitimate
20 expenses.

21 In fact, absent the existence of a settlement agreement, there would be no
22 legal basis for requiring APS to relinquish 10% of its cost recovery to ratepayers.³⁰

23 Under ratemaking principles enunciated by state and federal appellate courts
24 and embodied in the Arizona Constitution, a regulated utility must be allowed to
25 recover its prudently incurred costs of doing business and be given a reasonable
26 opportunity to earn a fair rate of return on the value of its property that is devoted
27 to public service.

28 Ratemaking by the Arizona Corporation Commission is governed by the "just
29 and reasonable" standard in the Arizona Constitution. (See Arizona Constitution,

²⁷ See Gehlen Direct @ 3

²⁸ See Gehlen Direct @ 7

²⁹ See Transcript @ 554-55

³⁰ See Transcript @ 346-47

1 Art. 15, § 3). The formulation of just and reasonable rates includes **recovery of the**
2 **utility's operating expenses**, valuation of its rate base and application of an
3 authorized rate of return to that rate base. (See *Residential Utility Consumer Office v.*
4 *Arizona Corporation Commission*, 199 Ariz. 588, 20 P.3d 1169 (2001) (citing *Scates v.*
5 *Arizona Corporation Commission*, 118 Ariz. 531, 578 P.2d 612 (1978); and *Public Utility*
6 *Commission of Texas v. Houston Lighting & Power Company*, 748 S.W. 2d 439 (Texas
7 1988).

8 In the context of a rate case, the applicable standard for determining whether
9 an operating expense should be recovered is whether it was prudently incurred. (See
10 *West Ohio Gas Company v. Public Utility Commission of Ohio*, 294 U.S. 63 (1935); and
11 *Butler Township Water Company v. Pennsylvania Public Utility Commission*, 473 A.2d
12 219, 221 (Pa. Commw. Ct. 1984); and *People's Organization for Washington Energy*
13 *Resources v. Washington Utilities and Transportation Commission*, 711 P.2d 319 (Wash.
14 1985).

15 The PSA, including the surcharge provision, is the product of Decision No.
16 67744, a ratemaking decision. The PSA is not an independent mechanism, for as
17 long as it is in effect, it is an extension of that decision.

18 Fuel and purchased power expenses are among the most fundamental
19 operating costs of an electric utility. The utility cannot serve customers without
20 incurring those expenses and it cannot survive long, especially in the current
21 environment, without recovering them.

22 While the hard cap may limit what can be recovered through the specific
23 mechanism of the PSA, it cannot foreclose recovery of fuel and purchased power
24 costs that are beyond the cap. Like the expenses that fall outside of the 4-mill
25 bandwidth, they are subject to full recovery in another proceeding. If the costs were
26 prudently incurred, the Commission is obligated to allow their recovery.

27 **CONCLUSION**

28 Pay now, or pay later.

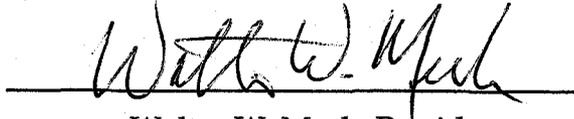
29 It is clear that APS has the right to recover the \$80 million of fuel and
30 purchased power expenses that is included in the amended surcharge application.
31 It is simply a question of when.

1 It is also clear from the evidence that it would be better for consumers if the
2 Commission would bite the bullet and apply the surcharge now rather than wait
3 until after the first PSA adjustment in April.

4 The April scenario would saddle consumers with incrementally higher costs
5 than the earlier action and would contribute to rate shock on summer bills.

6 Finally, if the Commission were to postpone action on the surcharge, it would
7 be rolling the dice on an adverse reaction from the rating agencies, which are
8 watching carefully to see how the PSA will be applied. There is no good reason for
9 the Commission to take such a risk.

10 Respectfully submitted this 16th day of November, 2005

11
12 
13 Walter W. Meek, President

14
15 **CERTIFICATE OF SERVICE**

16
17 An original and 15 copies of the foregoing brief
18 filed this 16th day of November, 2005, with:

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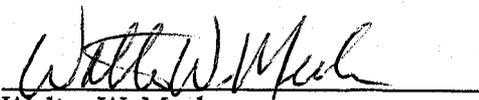
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