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BEFORE THE ARIZONA CORPORATION COMMISSION

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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
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 TEHREON, TO APROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN, AND FOR APPROVAL OF PURCHASED POWER CONTRACT.	DOCKET NO. E-01345A-03-0437 **STAFF'S POST-HEARING BRIEF**

I. INTRODUCTION

A. PSA Plan of Administration, Docket No. E-01345A-05-0437.

On April 7, 2005, the Commission adopted Decision No. 67744, which approves a Power Supply Adjustor ("PSA") for Arizona Public Service Company ("APS"). Although the terms of the PSA were primarily based upon a settlement agreement proposed by the parties, the Commission adopted several amendments to that proposal. The Commission also ordered the parties to file a joint plan of administration for the PSA by June 6, 2005.[1]

Although the parties subsequently provided a joint plan of administration for the Commission's review, the parties also indicated that some aspects of the plan remained in dispute. Specifically, Staff did not agree with the Company's proposals regarding wheeling costs, broker fees,

[1] In the original settlement agreement, the parties had contemplated that APS would develop and file the plan for administration for Staff approval. Decision No. 67744, Attachment A at 7. The Commission changed this provision, requiring the parties to submit a joint filing for Commission approval *Id.* at 42.

and the balancing account's $100 million cap. On June 6, 2005, Staff filed a memorandum that discussed the disputed issues. Although the matter was subsequently scheduled for an open meeting, it was removed from the open meeting agenda on August 9, 2005.

On September 12, 2005, the presiding ALJ held a procedural conference, which consolidated this matter with Docket No. E-01345A-05-0526 for purposes of hearing. On September 14, 2005, the parties filed a stipulated procedural schedule, which the ALJ accepted. A hearing was convened on October 26, 2005, and Staff now files this Post-Hearing Brief in lieu of a closing statement.

B. <u>Application for Surcharge, Docket No. E-01345A-05-0526</u>.

On July 22, 2005, APS filed an application asking the Commission to approve a PSA surcharge to amortize a projected under-collection of fuel and purchased power expenses. On September 12, 2005, the presiding ALJ held a procedural conference, which consolidated this matter with Docket No. E-01345A-03-0437 for purposes of hearing. On September 14, 2005, the parties filed a stipulated procedural schedule, which the ALJ accepted. A hearing was convened on October 26, 2005, and Staff now files this Post-Hearing Brief in lieu of a closing statement.

II. IS THE PLAN OF ADMINISTRATION PROPOSED BY THE PARTIES CONSISTENT WITH THE TERMS OF DECISION NO. 67744?

Staff believes that the Plan of Administration attached to Staff witness Keene's testimony is consistent not only with the terms of Decision No. 67744 but also with the terms of the settlement agreement proposed by the parties. Nonetheless, the record in this proceeding demonstrates that questions remain as to how the PSA was intended to operate. Specifically, it is unclear whether the Commission intended to create a single balancing account for recording the various PSA deferrals or whether the term "balancing account" refers solely to the deferrals associated with any "carryover" amounts remaining after the application of the various bandwidths.[2] The issue is succinctly summarized in the following exchange between CALJ Farmer and APS Witness Rumolo:

> Q. (By Judge Farmer) I think the question is whether there is a balancing account yet or not, under the terms of the settlement agreement.

[2] The operation of the two bandwidths is described in the prefiled testimony of Staff Witness Keene. <u>See</u> Keene Direct, Ex. S-1, Appendix 2 at 2-3.

> A. (By Mr. Rumolo) Yeah. And I think there has to be. There is, I don't think that's even—
>
> Q. I'm not disagreeing with you that there doesn't need to be a mechanism to track the differences in the actual costs versus the base costs. I'm not arguing with you about whether or not there needs to be a mechanism to do that. I'm just saying that I think there may be a difference in the definition of what we're calling a balancing account.

(POA/PSA Tr. at 98 (emphasis is added); *see also id.* at 42-43).

To summarize, the parties believe that the express terms of Decision No. 67744 and the settlement agreement contemplate a single balancing account. (POA/PSA Tr. at 27-29, 138-40, 153-54). By contrast, it appears possible that the Commission may have intended a separate and distinct balancing account for purposes of the "carryover" amount remaining after the application of the bandwidths. *See* POA/PSA Tr. at 42-43, 98. This section of the brief will describe these contrasting positions and will discuss the consequences of adopting each.

A. <u>Arguments in favor of a single balancing account</u>.

The Commission's discussion of the PSA in Decision No. 67744 provides the best starting point:

> 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.

Decision No. 67744 at 17 (emphasis added). This language uses the terms "balancing account" and "bank balance" interchangeably, thereby implying that they represent the same concept.

1. Testimony from the current proceeding.

This view is bolstered by the parties' testimony in the current proceeding. (POA/PSA Tr. at 138-40, 153-54). This testimony demonstrates that the parties believe that Decision No. 67744 and the underlying settlement agreement create a single balancing account, which is used to record all ongoing deferrals, including all inputs and all outputs that impact the resulting PSA bank balance.

(POA/PSA Tr. at 27-29, 151-52, 154). RUCO witness Diaz-Cortez's statements support this conclusion:

"[G]iven the term 'bank balance' and 'balancing account,' these are pretty common terms in regulation. Their interchangeability I think is comparable to the fact--or at least we saw it this way--of the fact--I mean, you could call a taxi or you could call a cab . . . ." (POA/PSA Tr. at 198-199). APS witness Rumolo also testified that the terms are interchangeable. (POA/PSA Tr. at 27-29).

Staff witnesses Gray and Keene compared the PSA balancing account to a bank account, which reflects deposits and withdrawals. (POA/PSA Tr. at 231-32, 251-53). In this analogy, the "bank balance" represents the total amount of dollars in the bank account at any point in time. These witnesses explained that the terms "balancing account" and "bank balance" reflect different aspects of the same concept. RUCO witness Diaz-Cortez provided a similar analogy when she compared the overall balancing account to a file cabinet and the bank balance to a file folder within that file cabinet. (POA/PSA Tr. at 149).

2. Testimony from the rate case.

Testimony from the rate case proceeding also supports the conclusion that Decision No. 67744 creates a single balancing account. APS witness Wheeler, while describing the operation of the PSA, made the following statements:

> A. (By Mr. Wheeler): [Y]ou actually use a base number. The number was derived from 2002 with some adjustments to it, but you start with a base number that is specified in the settlement. It's 2.07 cents. The number is in the settlement. And you use that as the base against which to compare a similar amount computed for fuel and purchased power costs in subsequent periods.
>
> Then with that difference, either plus or minus after dealing with the 90/10 split, requires an adjustment. And assuming it doesn't exceed four mils, then you make the adjustment the following year, and if it exceeds the four mil threshold or bandwidth, then the balance above the four mils is put in the bank balance and recovered later. **And there's also a trigger point of $50 million, so if things get out of hand one way or another, there's the opportunity for that to be addressed on something less than an annual basis.**
>
> Q. (By Commr. Mundell): I want to understand the adjuster rates will be as you just described. Then once a year on April 1st you guys are going to look at it and it's going to be adjusted up or down?

A. (By Mr. Wheeler): Yes Commissioner. We will be making a filing that will allow you to determine the appropriate adjustment. The first adjustment wouldn't be made until April, '06.

Q. That was my next question. The first adjustment would be April, '06?

A. **Unless the $50 million trigger was exceeded, in which case we could make a filing and we could determine whether to make an interim adjustment, assuming it isn't reached, then it would be '06 for the first adjustment.**

(Rate Case Tr. at 160-62 (emphasis added)).

Staff witness Johnson's rate case testimony echoes this theme:

> Certainly, 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 will have to be addressed. Let me tell you why I think that's important.
>
> You have had gas cases where, and this Commission, prior members of this Commission issued orders. What you have said is companies, when you reach a certain level of unrecovered costs, you need to come in. And the reason you come in is because as we're growing liability, right, owed by ratepayers, and at some point that balloon payment is going to come due, and **is it more responsible to mitigate or to deal with that balloon payment in increments that are more manageable as opposed to wait until it is not manageable.** So we think that this provision addresses this issue.

(Rate Case Tr. at 383-84 (emphasis added)). Both Mr. Johnson's and Mr. Wheeler's statements recognize that the settlement agreement allowed for the bank balance to be adjusted more frequently than once a year, if more frequent adjustments were necessary. This option was intended to serve as a sort of "safety valve" to provide the Commission with a ready means to address an escalating bank balance. This concept is also apparent in the following testimony from Mr. Wheeler:

> Mr. Chairman, the question of volatility is addressed at least to, we think in large degree from our customers' standpoint from having the collar around the level of adjustments that can be made in any particular year, a four mil bandwidth, if you will, that ensures there will not be great changes and spikes in terms of the fuel adjustment rate. **And we also have that combined with the $50 million trigger which gives you an opportunity to decide outside of the regular yearly review in your four mil bandwidth whether or not you want to make any other adjustments if the bank balance gets seriously out of whack.**

(Rate Case Tr. at 388 (emphasis added); *see also id.* at 391-93).

Finally, certain evidence suggests that APS' PSA was modeled after the adjustor mechanisms used for gas companies. (POA/PSA Tr. at 140-41,153; *see also* Rate Case Op. Mtg. Tr. at 301).

These other mechanisms commonly use a single balancing account. *See* Ex. APS-2; *see also* POA/PSA Tr. at 287-89.

3. Comments from the Commission's Open Meeting.

Certain comments offered at the Commission's open meeting suggest that the Commission intended to create a PSA mechanism that would require APS to seek prompt recovery of an escalating bank balance or risk disallowance. While addressing the amendment that proposed the $100 million cap, the discussion appears to focus upon preventing the accumulation of large bank balances:

> Chm. Hatch-Miller: And the intent of the language is to?
>
> Mr. Kempley: The intent of the language is to clarify what I think we all believe is the purpose of your amendment, and that is not to disallow costs, **but to ensure that a proceeding to examine the bank balance takes place both after the bank balance reaches $50 million, but before it could reach $100 million.**

(Rate Case Op. Mtg. Tr. at 313 (emphasis added). Others suggested that the proposed amendment would encourage APS to "bring an escalating bank balance" to the Commission's attention "well before it reaches $100 million . . . ." *Id.* at 314.

These statements suggest that the Commission viewed both the balancing account maintenance provisions set forth in Paragraph 19 and the Hatch-Miller amendment[3] as means to monitor the operation of the PSA as a whole and the status of the overall PSA deferrals in particular. To suggest that the triggers in Decision No. 67744 apply only when the carryover amount following an April reset reaches $100 million but not before the overall bank balance reaches $100 million is somewhat inconsistent with the Commission's discussion, which in several places suggests that the triggers are designed to ensure that APS will promptly bring an escalating under- or over-collection to the Commission's attention. (Rate Case Op. Mtg. Tr. at 264, 274-76, 281, 284, 294).

B. <u>Arguments in favor of a separate and distinct balancing account</u>.

Although Decision No. 67744 appears to use the terms "balancing account" and "bank balance" interchangeably, that result may merely reflect the parties' understanding of the terms,

[3] Chairman Hatch-Miller's amendment to the recommended order appears on page 16, line 28 – page 17, line 11 of Decision No. 67744.

rather than the Commission's express intent. The portion of the order at issue was originally an amendment to the ALJ's recommended order. (Rate Case Op. Mtg. Tr. at 308-315). This part of the amendment was actually drafted by the parties. *Id.; see also* POA/PSA Tr. at 43. In these circumstances, one could argue that the Commission's use of these terms was not deliberate.

In addition, the record in APS' recent rate case clearly shows that the parties expected the April reset to occur before the initiation of a surcharge application. Often, the testimony in the rate case described the PSA in terms of a sequence of events, beginning with the April reset and then proceeding to the amortization of the balancing account through a surcharge. *See, e.g.*, Rate Case Tr. at 1180-82; Rate Case Op. Mtg. Tr. at 295; POA/PSA Ex. S-4, S-5. This theme is also mirrored in the settlement agreement itself, which describes these steps in a particular sequence. *See* Decision No. 67744, Attachment A at 4-5. These comments could be interpreted as describing a **required** sequence of events, instead of an **expected** sequence of events.

C. <u>What are the practical consequences associated with this issue</u>?

Clearly, some sort of "balancing" or "tracking" account is necessary in order to implement both Paragraph 20 specifically and the PSA mechanism generally. (POA/PSA Tr. at 98). The issue, then, is not whether Paragraph 20 of the settlement agreement creates a "balancing account"--it clearly does--but whether the Paragraph 20 balancing account is necessarily separate and distinct from the balancing account created by Paragraph 19.

As the preceding sections were intended to illustrate, there is evidence to support both interpretations of Paragraphs 19 and 20. Specifically, one may reasonably conclude that these paragraphs create a single balancing account; however, it is not unreasonable to conclude that they create entirely separate accounts: a Paragraph 19 "balancing account" to record the "carryover" amounts resulting from the application of the bandwidths and an entirely separate Paragraph 20 account to comprehensively track the ongoing inputs and outputs that are used to calculate the PSA "bank balance." Perhaps the most reasonable inquiry in these circumstances is to focus less on what the parties intended and more on the varying consequences of the alternative interpretations.

1. The resulting differences between these competing interpretations affect the timing of recovery.

Staff believes that the resulting differences between the two constructions are primarily related to the **timing** of recovery. *See* POA/PSA Tr. at 157-59. If the Commission intended two separate balancing accounts, then APS probably may not file a surcharge request until after the April reset. If, on the other hand, the Commission intended a single balancing account, then APS must file a surcharge request when the applicable trigger is reached, which may occur before the April reset. In either circumstance, the Commission must approve the surcharge before APS may recover it from customers. (POA/PSA Tr. at 156, 158, 160-61).

If one were to conclude that the order creates only one balancing account for purposes of both Paragraphs 19 and 20, then that balancing account was established once the order became effective, and the triggers enumerated at page 17 of Decision No. 67744 apply to amounts recorded from the effective date of the order, which was April 1, 2005. Under this view, if the bank balance were to exceed $100 million, APS would risk disallowance if it failed to timely file an application for a surcharge.

On the other hand, if the Commission intended to create two separate balancing accounts--one for purposes of Paragraph 20 and another for purposes of Paragraph 19-- then the Paragraph 19 "balancing account" would not be established until after the April reset, and the triggers, by definition, could not apply until then. Under these circumstances, the $50 million trigger and the $100 million cap would only apply to the Paragraph 19 account, and APS would not be required to file a surcharge request pursuant to these triggers before the creation of the Paragraph 19 account, which would not occur until after the April reset. *See* Decision No. 67744 at 17, lines 13-16.

2. The resulting differences between these competing interpretations do not appear to affect the ultimate recovery of prudently incurred costs.

Staff surmises that an "automatic disallowance" might arise if the carryover amount remaining after the April reset were to exceed $100 million. Because the balancing account is capped at $100 million, it is possible that any amounts in excess could be summarily disallowed.

In the pending proceeding, however, APS has not addressed this concept. Furthermore, this idea appears to be at odds with the ALJ's description of the $776 million cap on APS' potential recovery of fuel and purchased power costs:

> 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 almost that $200 million. Under the recommended order, what happens is that if this were to happen in one year, if they were to reach that top the first year, and you've got the 200 million to 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 a 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.

(Rate Case Op. Mtg. at 249; *see also id.* at 250-51).

Decision No. 67744 limits APS' annual recovery of fuel and purchased power costs to approximately $776 million. According to Judge Farmer's comments, approximately $100 million of these costs may be recovered through the four mil adjustor, leaving approximately $100 million to be recovered through the surcharge. The difference between the $776 million cap and the amount that APS recovers in base rates may be sufficiently narrow to eliminate any potential for a disallowance occasioned by the operation of the balancing account's $100 million cap. *See* POA/PSA Tr. at 197-98. Of course, Judge Farmer's comments reflect her perspectives on the evidence of record; it is possible that actual experience may differ.

3. The resulting differences between these competing interpretations affect the accumulation of interest.

Paragraph 19(h) of the Settlement Agreement provides that "[t]he balancing account shall accrue interest . . . ." (Decision No. 67744, Attachment A at 5; *see also* POA/PSA Tr. at 158). If the Commission's order is construed as creating two separate balancing accounts--one for Paragraph 19 and another for Paragraph 20--and if the provisions of Paragraph 19 do not apply to Paragraph 20, then the Paragraph 20 balancing account is non-interest bearing. If, by contrast, the Commission's order creates a single balancing account, then that single account will accrue interest pursuant to Paragraph 19(h).

III. DOES THE PLAN OF ADMINISTRATION APPROPRIATELY INCORPORATE THE $776 MILLION CAP IMPOSED BY DECISION NO. 67744?

Staff believes that the $776 million cap limits the fuel and purchased power costs, attributable to any one year, that APS may recover. The amounts eligible for recovery may be collected by both the adjustor rate and the surcharge, and Staff believes that the proposed Plan of Administration appropriately reflects that conclusion. To the extent that APS' proposed PSA rate schedule is inconsistent with that conclusion, it should be rejected. *See* POA/PSA Tr. at 182-85.

IV. DOES THE PLAN OF ADMINISTRATION APPROPRIATELY IMPLEMENT THE $100 MILLION CAP ADOPTED BY DECISION NO. 67744?

Decision No. 67744 caps the balancing account at $100 million. That decision specifically states, "In no event shall the Company allow the bank balance to reach $100 million prior to seeking recovery or refund." Decision No. 67744 at 17. Questions have been raised as to whether this cap is intended to disallow PSA deferrals in excess of $100 million or to merely ensure a timely application to amortize an escalating bank balance. (Keene Direct, Ex. S-1 at 9). The proposed Plan of Administration resolves this question in favor of the latter view. *Id.* at 9-10. Staff believes that this interpretation provides a reasonable resolution of this issue. *Id.* at 10; *see also* Op. Mtg. Tr. at 270-71, 274-76, 284.

V. STAFF RECOMMENDS APPROVAL OF APS' REQUESTED $0.001416 PER KWH SURCHARGE.

On July 22, 2005, APS filed an application asking the Commission to approve a PSA amortization surcharge due to a **projected** under-collection of fuel and purchased power expenses. APS predicted that this under-collection would reach $100 million by August 31, 2005. (Gehlen Direct, Ex. S-2 at 3). According to APS, its **actual** under-collected fuel and purchased power expenses total $127.7 million for the period April 1, 2005-August 31, 2005. *Id.* at 8. APS has deferred $115.2 million of this amount in compliance with the 90/10 sharing mechanism adopted in Decision No. 67744.

APS subsequently agreed to remove $20 million related to Palo Verde outages from its surcharge request. *Id.* at 3. As a result, APS is now requesting a surcharge that will amortize $80

million over a recovery period of twenty-four months. *Id.* If approved, the resulting surcharge will amount to $0.001416 per kWh, an approximate 1.7 percent revenue increase relative to the cost of fuel and purchased power recovered in base rates ($0.0220743). *Id.* APS has asked for the surcharge to become effective for the first billing cycle in November. *Id.*

In its evaluation of APS' request, Staff examined APS' load growth, generation mix, and fuel and purchased power costs. *Id.* at 10. Staff's analysis indicates that the costs of natural gas and purchased power are increasing, and APS' base cost of fuel and purchased power, which is based upon 2003 data, is not sufficient to keep pace with these increasing costs. *Id.* at 10-11. Staff also determined that the under-collected balance is unlikely to self-correct. (POA/PSA Tr. At 664). Although additions to APS' under-collected balance should slow during the last quarter of the year, this phenomenon will not be sufficient to offset the existing under-collection. (Gehlen Direct, Ex. S-2 at 8).

Staff therefore recommends approval of APS' requested $0.001416 per kWh surcharge. *Id.* at 12. In testimony, Staff specifically acknowledged the burden that this surcharge will place on APS' customers. *Id.* at 9-11. Staff concluded, however, that "rejecting or delaying the Company's application" will not result in "any long-term benefits" for customers. *Id.* at 11. Staff believes that addressing the current under-collection now will allow the effects of increased fuel and purchased power costs to be spread over time, thereby easing the impact on ratepayers. *Id.*

Staff has not reviewed the prudence of the costs associated with APS' requested surcharge. (*Id.* at 11-12; POA/PSA Tr. At 657). Prudence reviews are complex and time consuming, and the aggressive procedural schedule adopted for this proceeding left insufficient time to review APS' operations with the level of scrutiny that a prudence review requires. (Gehlen Direct, Ex. S-2 at 4). In the coming year, Staff plans to conduct prudence reviews of APS' operations in general and its nuclear operations in particular. (POA/PSA Tr. at 655-56). This review will include--but not be limited to--an examination of the $80 million embodied in APS' surcharge request and the $20 million associated with the Palo Verde outages that were withdrawn from this proceeding.

Finally, Staff witness Gehlen recommended certain modifications to APS' monthly PSA reports to enable Staff to evaluate the reports more quickly and comprehensively. (Gehlen Direct,

Ex. S-2 at 12. APS witness Ewen generally accepted those modifications but also offered certain clarifications. (Ewen Rebuttal, Ex. APS-7 at 1-4). Staff does not object to those clarifications.

VI. CONCLUSION

Regarding Docket No. E-01345A-03-0437, Staff recommends that the Commission approve the Plan of Administration that appears as Appendix 2 to the testimony of Staff witness Keene.

Regarding Docket No. E-01345A-05-0526, Staff offers the following recommendations: the Commission should approve APS' requested $0.001416 per kWh surcharge in order to amortize $80 million of its deferred fuel and purchased power costs over a twenty-four month period, the Commission should require APS to modify its PSA reports as described in the testimony of Staff witness Gehlen and APS witness Ewen, and the Commission should specifically reserve the right to subsequently review the prudence of any matter raised in this proceeding.

RESPECTFULLY SUBMITTED this 21st day of November, 2005.

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