



0000038288

**ORIGINAL
EXCEPTION RECEIVED**

BEFORE THE ARIZONA CORPORATION COMMISSION

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

COMMISSIONERS

2006 JAN 13 P 3:50

JEFF HATCH-MILLER, Chairman AZ CORP COMMISSION
WILLIAM A. MUNDELL DOCUMENT CONTROL
MARC SPITZER,
MIKE GLEASON
KRISTIN K. MAYES

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
PURCHASED POWER CONTRACTS

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

**EXCEPTIONS TO
RECOMMENDED ORDER
OF
ARIZONA PUBLIC SERVICE
COMPANY**

I. INTRODUCTION

Pursuant to A.A.C. R14-2-110, Arizona Public Service Company ("APS" or "Company") hereby submits to the Arizona Corporation Commission ("Commission") its Exceptions to the Recommended Opinion and Order ("Recommended Order") issued by the Chief Administrative Law Judge ("CALJ") on January 4, 2006. As written, the Recommended Order:

- (1) threatens the fundamental creditworthiness of APS;

1 (2) adopts an elaborate technical argument that will essentially frustrate the
2 clear intent of Decision No. 67744 to use the power supply adjustor
3 (“PSA”) surcharge mechanism as a “safety valve” to address large
4 buildups of uncollected fuel and purchased power in between the
5 annual recalculation of the PSA factor in March of each year;

6 (3) discusses the issue of the \$776.2 million “cap” on annual recoveries of
7 prudently-incurred fuel and purchased power costs (“Annual Cap”) in
8 a way that suggests both that:

9 a. APS is somehow at fault for reaching the Annual Cap
10 earlier than had been anticipated by the parties and the
Commission; and

11 b. the Annual Cap will, in fact, cause an automatic
12 disallowance of costs in 2006 irrespective of APS’ efforts
13 to prudently manage its fuel and purchased power costs
14 and despite the fact that APS has pending not one but two
rate proceedings asking for relief from the Annual Cap
(See Docket Nos. E-01345A-05-0816 and E-01345A-06-
0009) (Recommended Order at 15);

15 (4) proposes changes to the PSA Plan of Administration (“POA”) that for
16 the most part can be implemented independently of the Recommended
17 Order’s position on the PSA surcharge or the specific rationale
18 suggested for such changes in other portions of the Recommended
19 Order.

20 APS will request in these Exceptions (and in proposed amendments to the
21 Recommended Order) that the Commission reject the CALJ’s arguments relative to the
22 timing of any PSA surcharge. But if the Commission nevertheless agrees with the
23 Recommended Order’s reasoning, APS still believes the Commission can and should
24 adopt the requested PSA surcharge of \$.001416 per kWh, albeit with an effective date
25 coincident with the first resetting of the annual PSA factor on April 1, 2006. (See
26 Recommended Order at 20, lines 1-3 and also ft. nt. 18.) Clearly, the Recommended

1 Order's focus was on the timing of the PSA surcharge. The record reflects universal
2 agreement by the parties that the requested surcharge was appropriate and necessary.
3 This delayed implementation of the requested surcharge would still be in time to reduce
4 the size of the April 2006 annual PSA adjustor.

5 The Commission should also delete what is mere conjecture about and a
6 fundamental misunderstanding of APS hedging practices. Indeed, it should take this
7 opportunity to clarify its intent relative to the continuance of cost deferrals for amounts
8 above the Annual Cap pending a final order in the Company's rate case.

9 Finally, APS believes the changes to the POA in the Recommended Order can be
10 added to the modified POA already filed by Staff without establishing four separate
11 accounts, but rather through four additional schedules accomplishing the same tracking
12 function as suggested by the CALJ. The Commission's final order should also clarify
13 that interest will be accrued on all under-recovered/over-recovered amounts in the PSA
14 bank balance, including the un-recovered portion of any PSA surcharge or annual PSA
15 adjustor, as well as the sales (historic or projected) to be used in the calculation of both
16 PSA charges. Subject to these incremental changes, the joint POA should be deemed
17 approved with these incremental changes.

18 APS will discuss in more detail each of these issues below. For the convenience
19 of the Commission, the Company has also attached proposed amendments to the
20 Recommended Order addressing its concerns.

21 II. SUMMARY

22 Before getting into the debate over the fine points of Decision No. 67744, the
23 2004 APS Settlement Agreement ("Settlement"), it is important for the Commission to
24 keep in mind some more global and undisputed facts. These are:

- 25 1) Every witness in this proceeding supported the requested PSA
26 surcharge, and no party opposed it.

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

- 2) The Company's un-recovered fuel and purchased power costs were well over \$100 million through the end of October, 2005 and have been so since August 2005. (APS Exhibit 4, Testimony of Steven M. Wheeler, at 2 and 3; APS Exhibit 6, Testimony of Peter M. Ewen, at 2 and 3; Staff Exhibit 2, Testimony of William Gehlen, at 3; and Gleason Exhibit 1 at 3.) By year end 2005, this under-recovery (including interest) reached over \$170 million.

- 3) Without timely relief, the cumulative under-recovery by year-end 2006 is now anticipated to be well over \$400 million. Even if the full PSA surcharge request is granted and even with an increase in the annual PSA adjustor in April 2006, these under-recoveries, and hence the PSA bank balance, will continue to climb to well over \$200 million.¹ (APS Exhibit 4, Testimony of Steven M. Wheeler, at 4 and 9; APS Exhibit 5, Testimony of Peter M. Ewen, at 6; and Staff Exhibit 2, Testimony of William Gehlen, at 8.)

- 4) This under-recovery has occurred and will continue to occur throughout 2006 despite an aggressive hedging program aimed at reducing price risk to customers rather than meeting some specific cost target (the gas price workshop held on September 8, 2005 indicated that APS hedged significantly more of its needs than do other Arizona utilities) – a program that had saved APS customers some \$30 million from April

¹ This is true irrespective of whether the Commission eliminates or increases the cap on annual retail fuel and purchased power costs, presently established at \$776.2 million, as requested by APS in its rate case filing of November 4, 2005.

1 through August of 2005, (APS Exhibit 5, Testimony of
2 Thomas J. Carlson, at 12) and nearly \$120 million for all of
3 2005. That same program has locked in gas and power
4 supplies for 2006 that are presently below forward market
5 prices.

6 5) APS has been either downgraded or put on credit watch for a
7 downgrade by every major rating agency since the hearing in
8 this matter due to the failure to address skyrocketing under-
9 recoveries of fuel and purchased power costs. Further adverse
10 rating actions to "junk bond" status have been threatened that
11 could cost customers an additional \$1 BILLION over the next
12 decade.

13 6) Despite the desire of some to ignore or dismiss the views of
14 rating agencies and of the capital market in general, these
15 perceptions independently control the Company's access to
16 and price of the capital needed to conduct its business. Failure
17 to recognize, understand and respond to this unalterable truth
18 puts APS and its over one million customers in great peril.

19 **III. THE REQUESTED PSA SURCHARGE IS SUPPORTED BY**
20 **ALL THE EVIDENCE OF RECORD AND IS CRITICAL TO**
21 **THE COMPANY'S FINANCIAL INTEGRITY**

22 Again, no party opposed the requested surcharge, and all the witnesses in the
23 proceeding supported it. However, the Recommended Order denies the requested PSA
24 surcharge because it concludes that there is nothing in the "balancing account"
25 referenced by Paragraph 19(d) and Paragraph 19(e) of the 2004 APS Settlement to which
26 a surcharge could apply. The Recommended Order does not dispute the fact that APS
under-collected its fuel and purchased power costs during 2005 or that this under-

1 collection will continue in 2006 even if the full four mill PSA adjustment is implemented
2 on April 1, 2006.

3 While APS will discuss its disagreement with the “balancing account” analysis
4 made by the Recommended Order in the next Section of its Exceptions, the Company
5 must again reiterate that more than a debate over the sequencing of PSA charges is at
6 stake in this proceeding, Put directly, the capital market has lost its patience with any
7 further inaction to address the payment of these IOUs:

8 The draft decision [Recommended Order] recommends denying APS’
9 request to recover \$80 million in deferred costs until after the first power
10 supply adjustment, which will not occur until April 2006. Even if APS’
11 surcharge request had been implemented in January 2006, as Standard &
12 Poor’s had expected, the \$80 million addresses a mere fraction of mounting
13 deferrals that are projected to continue severely straining company cash
14 flows. [S&P Research Bulletin, January 5, 2006.]

12 * * *

13 Standard & Poor’s Ratings Service last month lowered the corporate credit
14 rating of APS and PWCC by one notch, to BBB- [BB+ in the case of
15 PWCC], based on concerns that the regulatory process in Arizona is not
16 providing the company timely recovery of fuel and purchased power costs.
17 Irrespective of the merits of the technicalities in the ALJ’s
18 recommendation, the draft decision, if implemented, will compound a
19 mounting deferral problem that is severely straining cash flow. [S&P
20 Research Summary, January 6, 2006, p.1.]

17 * * *

18 The stable outlook [of APS] reflects Standard & Poor’s expectation that the
19 ACC will move promptly to address APS’ need for rate relief in light of
20 steadily increasing fuel and purchased power deferrals. In the absence of
21 such action, an adverse rating action or a change in the outlook is likely.
22 [Id. at 2]

21 * * *

22 Moody’s Investors Service placed the long-term [debt] ratings of Pinnacle
23 West Capital Corporation (Pinnacle: Baa2, senior unsecured and its
24 subsidiaries Arizona Public Service Company (APS: Baa1, senior
25 unsecured) and PVNGS II Funding Corp., Inc. (PVNGS II: Baa1, senior
26 secured lease obligation bonds) under review for possible downgrade. . . .
The rating review follows a recommendation of an Arizona administrative
law judge that APS’s application for a special rate surcharge be denied. The
review is prompted by deterioration in the company’s current and projected

1 financial metrics as a result of increased fuel and purchased power costs
2 that the company has not been able to recover on a timely basis.

3 The review will focus on the outcomes of the various rate requests that APS
4 has filed or is expected to file with the Arizona Corporation Commission
5 (ACC). . . .

6 . . . An assessment of likely regulatory outcomes will be a significant factor
7 in concluding the review for downgrade. The ratings of APS and Pinnacle
8 are likely to be downgraded unless there are clear signals that APS will
9 receive timely and full recovery of its increased costs such that we would
10 expect their credit metrics to return to levels commensurate with those of
11 similar rated utility companies. [Moody's Investors Service Rating Action
12 dated January 10, 2006.] [Emphasis supplied.]

13 * * *

14 If adopted, the ALJ decision would delay consideration of APS' request to
15 recover \$80 million of deferred power supply charges to April 2006, at the
16 earliest. The continued delay is inconsistent with Fitch's assumption in
17 2005 that the ACC would implement the PSA by the end of 2005, which
18 was a key element supporting the Stable Rating Outlook for APS and PNW
19 (see Fitch's Update Report and Credit Analysis regarding PNW and APS
20 dated July 29, 2005 and May 4, 2005, respectively, available on the Fitch
21 web site at 'www.fitchratings.com'). In Fitch's view, the regulatory
22 uncertainty and prospect of further delay to the recovery of prudently
23 incurred power supply costs is a threat to APS and PNW's creditworthiness,
24 especially in light of the company's high and growing reliance on natural
25 gas and purchase power. While the ALJ proposed order does not bind the
26 ACC, it casts meaningful uncertainty on the commitment of Arizona
regulators to permit timely recovery of fuel and purchase power costs by
APS. Conversely, an ACC order rejecting the ALJ recommendation and
authorizing full recovery of the requested deferral balance of \$80 million on
a timely basis would support a more favorable resolution of the Negative
Rating Watch for APS and PNW [Fitch Ratings Release dated January 6,
2006.] [Emphasis supplied.]

19 IV. THE RECOMMENDED ORDER'S INTERPRETATION OF 20 PARAGRAPH 19 OF THE SETTLEMENT IS INCORRECT

21 As noted earlier, the Recommended Order concludes that at the time of the
22 Company's surcharge request, the "balancing account" referenced in Paragraph 19(d)
23 and Paragraph 19(e) of the Settlement did not have any dollars associated with them. At
24 the same time, the Recommended Order acknowledges the need for a balancing account
25 mechanism to record net deferrals of fuel and purchased power costs (after the 90/10
26 sharing) that are in excess of fuel and purchased power cost recoveries through the base

1 fuel rate. Thus, the Recommended Order creates what it terms an “Annual Tracking
2 Account.” Recommended Order at 15-16. It further concludes that this new balancing
3 account, which is found no place in the Settlement, the hearing record or Decision No.
4 67744 is also what was being referenced in Paragraph 20(a) of the Settlement.
5 Recommended Order at 14. That latter provision requires APS to report information on
6 the PSA balancing account beginning with the very first monthly PSA report. (Tr. Vol. I
7 at 138; and Tr. Vol. II at 286.) Under the Recommended Order, the “Annual Tracking
8 Account” is used to determine the annual resetting of the PSA Adjustor but apparently
9 has no other purpose.

10 The Recommended Order then determines that the “balancing account”
11 referenced in both Paragraph 19(d) and Paragraph 19(e) is some different and separate
12 “balancing account,” denominated by the Recommended Order as the “Paragraph 19(d)
13 Balancing Account.” Recommended Order at 16. The Recommended Order goes on
14 further to posit two additional balancing accounts – one to keep track of the annual
15 adjustor (“Annual Adjustor Account”) and another to track any PSA surcharge
16 (“Surcharge Account”). *Id.*

17 The Recommended Order professes that: “We want a [PSA] Plan of
18 Administration that is clear, simple to understand, and is easy for APS and Staff to
19 follow.” Recommended Order at 15. But this laudable goal is not served by going from a
20 single PSA balancing account – a concept supported by all the parties to the Settlement
21 and which is well-grounded in past Commission practices with regard to gas utilities - to
22 four separate “balancing accounts,” each serving a different purpose.

23 There is a centuries-old principle in science called “Occam’s razor.” Occam’s
24 razor reasons that the simplest explanation of a situation is usually the best. Using a
25 single PSA balancing account rather than four is consistent with this principle. It is
26 consistent with the universal position of those parties that negotiated and drafted the

1 Settlement. And it is consistent with language of Paragraph 19, which references “a”
2 balancing account [Paragraph 19(d)] and “the” balancing account [Paragraph 19(e)].
3 (Emphasis supplied.)

4 Aside from adding three more layers of complexity, what purpose is served by
5 this rewriting of the PSA mechanism? Certainly, charging one’s debts to four credit card
6 accounts rather than one does not reduce the total balance owed. But more important
7 than the question of intent are the consequences of the Recommended Order’s argument.
8 First, it delays but does not change the need for a PSA surcharge. Recommended Order
9 at 12. Another consequence is to assure that the deferred under-collections of fuel and
10 purchased power costs in the “Annual Tracking Account” can exceed \$100 million, and
11 indeed can reach an amount limited solely by the overall “cap” of \$776.2 million prior to
12 APS being either able or required to seek a surcharge. This not only conflicts with
13 Chairman Hatch-Miller amendment’s mandate to keep these deferrals within somewhat
14 manageable levels (defined as under \$100 million) through the surcharge “safety valve”
15 provision, it actually negates the amendment in its entirety by effectively defining the
16 problem out of existence until the \$776.2 million “cap” can eventually “solve” the
17 deferral problem by disallowing them. Recommended Order at 15.

18 The Recommended Order bases much of its interpretation of the PSA mechanism
19 on the fact that what discussion there was of a PSA surcharge during the Special Open
20 Meeting was in conjunction with the four mill annual adjustment and also the fact that
21 APS witness Donald Robinson did not address the PSA surcharge in his Settlement
22 testimony. Recommended Order at 6-7 and 8-9. Moreover, the Recommended Order
23 notes that APS Exhibit 18, which compared the Settlement rates with those originally
24 requested, did not include a line item for a PSA surcharge.

25 The former discussion was largely framed by the parties’ response to a request by
26 Commissioner Mayes to determine the combined impact of the four mill adjustment and

1 a \$100 million PSA surcharge. The sequencing of these PSA charges was not specified
2 by Commissioner Mayes' request nor would it have been relevant to the point she was
3 trying to make with her "homework assignment."

4 During the hearing on the settlement, no party asked about the sequencing of the
5 two PSA charges with the singular exception of Commissioner Mundell's direct question
6 to APS Executive Vice-President, Steve Wheeler, which exchange is not cited in the
7 Recommended Order:

8 Q. [From Commissioner Mundell] That was my next question. The first
9 adjustment would be April, '06?

10 A. BY MR. WHEELER: Unless the \$50 million trigger is exceeded, in which
11 case we could make a filing and you could determine whether to make an
12 interim adjustment, [but] assuming it isn't reached, then it would be '06 for
the first adjustment. [Settlement hearing Tr. Vol. I, p. 162. Emphasis
supplied.]

13 No further inquiries were made, and so it was reasonable for the parties, including APS,
14 to assume that the sequencing of possible PSA charges was not an issue with the
15 Commission. Moreover, APS Exhibit 18 would not have presumed a 2006 PSA
16 surcharge (or a surcharge in any other year, for that matter) because at the time there was
17 no requirement that APS seek a PSA surcharge, the granting of such a surcharge would
18 have been discretionary on the part of the Commission in any event, and with what was
19 then a four mill annual cap on PSA adjustments instead of a cumulative four mill cap,
20 the need to either request or impose a surcharge was markedly less. Finally, the Exhibit
21 referred to "potential 2006 adjustments," and even the Recommended Order concedes
22 that a PSA surcharge could be authorized as soon as April 1, 2006. In short, the only
23 portion of record directly addressing the issue of sequencing was the clear and
24 unambiguous statement by Mr. Wheeler that a surcharge was possible prior to April 1,
25 2006.

26

1 Lastly, Mr. Robinson's lack of discussion of a PSA surcharge in his Settlement
2 testimony cannot change the fact that the Settlement itself clearly permitted such a
3 charge under specified circumstances and when approved by the Commission. Also,
4 Staff witness Bob Gray did address the PSA surcharge mechanism in his Settlement
5 testimony, as did APS witness David Rumolo in his rate case rebuttal testimony, which
6 was specifically incorporated into the Settlement hearing record.

7 In sum, what we have here is a failure of circumstances to match expectations. It
8 was the expectation of Staff and likely the Commission that fuel costs would not escalate
9 so quickly as to reach the levels actually experienced in 2005 and continuing into 2006.
10 And no party anticipated two devastating hurricanes that struck the heart of gas
11 production in the Gulf of Mexico, Louisiana and East Texas, or a record run-up in oil
12 prices (thus increasing further the demand for natural gas and hence its price). After all,
13 Staff's "worse case" scenario had 2006 gas prices at \$7.60 per MMBTU – some \$3 less
14 than what we now face. But the fact that the present circumstances were unanticipated
15 back in the early spring of 2005 neither lessens their impact nor alters the critical need to
16 address the mounting pile of regulatory IOUs that is literally bleeding APS into "junk
17 bond" status, with all the dire ramifications to customers of such a loss of fundamental
18 financial integrity.

19 In the attached Proposed APS Amendment No. 1, APS does not propose to
20 rewrite the Recommended Order's extensive discussion of the 2004 APS Settlement or
21 the evidentiary record thereof and the March 2005 Special Open Meeting. Rather, it
22 simply notes the need for the requested PSA surcharge and the unanimous support of
23 such a surcharge by the witnesses in the hearing. It deletes much of the remaining
24 discussion and findings of the Recommended Order to the contrary and further requests
25 the CALJ to make all conforming changes.

26

1 APS is also attaching an Alternative Proposed APS Amendment No. 1 that
2 accepts with the Recommended Order's conclusion that a PSA surcharge cannot be
3 implemented prior to April 1, 2006, but which under the circumstances treats the instant
4 Application as such a request for delayed relief and approves the PSA surcharge of
5 \$.001416 per kWh, effective for billings on or after April 1, 2006. The Alternative
6 Amendment further directs APS to take the approved PSA surcharge into account when
7 making its filing on or before March 1, 2006 for the annual PSA adjustment. This will
8 eliminate the potential for any "double-counting" of cost recovery for the year-end 2005
9 PSA balances and reduce the size of the April adjustment.

10 V. ANNUAL CAP

11 The Recommended Order suggests that APS should manage its fuel and
12 purchased power procurement to avoid the potential impact of the Annual Cap in 2006.
13 Recommended Order at 15. It cites no evidence that this was either possible or prudent
14 nor offers any suggestions as to how that might have been accomplished other than
15 through "targeting its hedges." *Id.* Whereas APS already hedges far more of its
16 anticipated needs than any other utility regulated by the Commission and was already
17 85% hedged for 2006 by the end of August 2005, it is not clear how APS could have
18 reasonably done more without leaving itself no leeway for variations in its 2006
19 projected load and no potential for availing itself of market opportunities, which
20 invariably exist from time to time in even tight energy markets. Moreover, the objective
21 of hedging, in contrast to speculation, is to insure against unanticipated price increases
22 and not to reduce prices in an absolute sense.

23 The facts are simple: (1) APS is in a fast growing service territory; (2) significant
24 portions of its load is weather-dependent; (3) marginal energy prices, whether at APS-
25 owned units or from the competitive wholesale market, are linked to gas, meaning that
26 average unit fuel costs and total fuel costs will increase faster than base fuel revenues;

1 (4) both the opportunities for profitable off-system sales and the profitability of what
2 sales can be made are adversely impacted by higher gas prices. All of these factors
3 inevitably will drive fuel and purchased power costs over the Annual Cap. It was only a
4 question of “when” and never “if.” Indeed, the only alternative to exceeding the Annual
5 Cap would be to cease providing service – something APS, unlike unregulated firms,
6 does not have the ability to do.

7 The Recommended Order also appears to suggest that there is something
8 improper about APS’ two pending requests to raise or eliminate the Annual Cap.
9 Recommended Order at 15. Yet, this was precisely what Decision No. 67744 suggested
10 that the Company do. As noted in both its permanent rate filing of November 4, 2005
11 and its Emergency Interim Rate Application of January 6, 2006, the stated goal of the
12 Annual Cap was to force another APS rate case sooner rather than later and not to
13 arbitrarily disallow costs.

14 We believe APS must have an incentive to file a rate case so we can
15 determine the accuracy of its assertions about expenses. Decision No.
16 67744 at 17.

17 Because the PSA actually adjusts for growth, putting a ‘cap’ on recovery
18 of these costs will help ensure that APS will file a rate case application
19 when necessary. *Id.*

20 Since there is no moratorium on filing a rate case, APS can file a rate case
21 to reset base rates if it deems it necessary because that cap is reached. *Id.*

22 Decision No. 67744’s discussion of the \$776.2 million “cap” is consistent with
23 the Commission deliberations during the Special Open Meeting to consider the 2004
24 APS Settlement. Chairman Hatch-Miller specifically indicated that the purpose of the
25 “cap” was to require APS to come in for another rate proceeding. Tr. Vol. I at 43, lines
26 12-15. And three other Commissioners acknowledged that these various “caps” were
not intended to cause arbitrary disallowances of otherwise prudent fuel and purchased
power costs. Tr. Vol. II at 242, lines 1-7; 256, lines 1-6; 261, lines 13-16; 276, lines 7-

1 11; and 279, lines 13-14. Similarly, the discussion indicated that given then prevailing
2 fuel prices, it was not anticipated that the “cap” would be reached until between 2007
3 (APS spokesman Steve Wheeler: Tr. Vol. II at 294, lines 19-21) and 2010
4 (Commissioner Gleason: Tr. Vol. II at 235, lines 24-25 and 230, lines 1-2).

5 The Recommended Order has suggested one interpretation of the Annual Cap –
6 one having the potential to automatically disallow otherwise recoverable fuel and
7 purchased power costs, a result contrary to the stated intentions of the Commission and
8 to applicable legal authority.² APS would suggest that the Commission now take this
9 opportunity to clarify its original intent relative to the Annual Cap. In Proposed APS
10 Amendment No. 2, the second paragraph of page 15 in the Recommended Order is
11 replaced in its entirety with language indicating that APS is authorized to defer for future
12 recovery prudently-incurred fuel and purchased power costs in excess of the Annual Cap
13 until the Commission can address the Company’s request to eliminate the “cap” ruling in
14 Docket No. E-01345A-05-0816.

15 VI. POA

16 Although APS has taken strong Exception to the Recommended Order’s technical
17 arguments against the requested \$80 million PSA surcharge and its discussion of the
18

19 ² The Company’s legal right to full recovery of all prudent costs of providing electric service to the public
20 is unquestioned. In *Scates v. Arizona Corporation Commission*, 118 Ariz. 531, 578 P.2d 612 (App. 1978) the Court
21 held that “rates established by the Commission should meet the overall operating costs of the utility and produce a
22 reasonable rate of return.” *Id.* As such, the Court of Appeals followed the Supreme Court’s earlier holding in
23 *Arizona Corporation Commission v. Arizona Water Co.*, 85 Ariz. 198, 335 P.2d 412 (1959), which stated: “it [the
24 utility] is entitled to a fair return on the fair value of its properties devoted to public use, no more and no less.”
25 (Emphasis supplied.) See also *Wisconsin Public Service Corporation v. Public Service Commission of Wisconsin*,
26 325 N.W. 2d 867 (Wisc. Sup. Ct. 1982) (public service commission’s decision to disallow full recovery of
prudently-incurred costs to reduce burden of cost recovery on ratepayers lacked rational basis, was arbitrary, and
had no basis in sound public policy). Moreover, in setting rates, the Commission has an equal responsibility to
protect both customers and shareholders of the utility. *Arizona Community Action Association v. Arizona
Corporation Commission*, 123 Ariz. 228, 599 P.2d 184 (1979); see also *Salt River Valley Canal Co. v. Nelssen*, 10
Ariz. 9, 85 P.117 (1909). APS does not believe the Commission’s admitted responsibility to consider the interests
of utility consumers allows it to disregard Constitutional and other legal protections against the confiscation of
utility property by requiring the utility to serve at rates that do not recover its costs and provide for a fair return.

1 Annual Cap, the Company certainly agrees that the POA should be “clear, simple to
2 understand, and easy for APS and Staff to follow.” Recommended Order at 15. To that
3 end, APS has no objection to providing additional detail concerning the various revenues
4 and expenses that go into the PSA bank balance along the lines discussed by the
5 Recommended Order at page 16. These specific items (the month to month differences
6 between fuel and purchased power costs and the base fuel rate, the comparison between
7 anticipated recoveries under the annual PSA adjustment with actual recoveries, the
8 portion of the prior year-end PSA balance that is neither reflected in the annual PSA
9 adjustment nor any authorized surcharge, etc.) can be identified and reconciled with the
10 overall PSA deferral balance in a manner that allows the reader to identify what portion
11 of the deferrals have been addressed through one or more cost recovery mechanisms and
12 what portion is still unaccounted for in the regulatory process. This does not mean,
13 however, that there is more than one PSA balancing account or that either APS or
14 customers should be denied carrying charges on any portion of that account³, depending
15 on whether it is positive or negative. Thus, the POA proposed jointly by the parties to the
16 Settlement and sponsored by Staff witness Keene should be approved with the above
17 incremental changes and with the additional reporting requirements discussed at page 19
18 of the Recommended Order.

19 The Recommended Order also proposes using projected sales for calculating both
20 the annual PSA adjustment and any PSA surcharge. Recommended Order at 16. The
21 latter suggestion is already reflected in the Company’s requested PSA surcharge of
22 \$.001416 per kWh, although APS does not object to specifying this in the POA. The
23 former was part of the original APS position on the PSA for the very reasons posited by
24 the Recommended Order but was dropped during settlement negotiations in favor of the

25 ³ APS has agreed with Staff that it would need to request interest on the unrecovered portion of what the
26 Recommended Order calls the “Surcharge Account.” Recommended Order at 16. However, in this
proceeding, APS has requested such interest and does not believe any party has opposed this request.

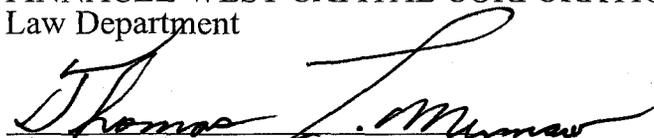
1 historical sales figures preferred by other parties. If the Commission agrees with the
2 CALJ that projected sales should also be utilized in calculating the size of the annual
3 PSA adjustment, this additional incremental change would need to be made to the POA
4 submitted by the parties to the settlement.

5 VII. CONCLUSION

6 The need to address the Company's mounting under-collection of fuel and
7 purchased power costs can no longer be ignored or postponed. Hard decisions do not
8 grow easier when delayed, but the adverse consequences to APS and its customers of
9 that delay will be both immediate and long lasting. APS asks that the Commission not
10 lose sight of the growing forest of substantive financial distress being experienced by the
11 Company while entangling itself in the underbrush of semantics about procedure and
12 that it adopt its Proposed Amendments to the Recommended Order.

13 RESPECTFULLY SUBMITTED this 13th day of January, 2006.

14 PINNACLE WEST CAPITAL CORPORATION
15 Law Department

16 
17 Thomas L. Mumaw
Karilee S. Ramaley

18 and

19 SMELL & WILMER L.L.P.

20 
21 Deborah Scott

22 Attorneys for Arizona Public Service Company

23 Original and 15 copies of the foregoing were
24 filed this 13th day of January, 2006, with:

25 Docket Control

26 Arizona Corporation Commission

1200 West Washington

Phoenix, AZ 85007.

1 Copy of the foregoing mailed, hand-delivered or
2 e-mailed this 13th day of January, 2006 to:

3 All parties of record.

4 Vicki DiCola
5 Vicki DiCola

6

7

8

9

10

11

12

13

14

15

16

17

18

19

20

21

22

23

24

25

26

PROPOSED APS AMENDMENT NO. 1

- DELETE: Page 10, line 13, starting with "However, were we..." through line 28.
- DELETE: Page 11, lines 1-4, and line 19, starting with "So it is clear..." through line 26
- DELETE: Page 12, lines 1-7 and
lines 13 - 28.
- DELETE: Page 13, lines 1-5;
- ADD: Page 13, line 16, after "it had not", add the word "specifically".
- DELETE: Page 13, line 26 and 26 1/2 [footnote 12].
- DELETE: Page 14, line 1: "and capped the balancing account to \$100 million"
REPLACE WITH: "required action by APS before the balancing account reaches \$100 million"
- DELETE: Page 14, line 23: "after the adjustor rate is set"
- DELETE Page 15, line 23: "annual tracking mechanism"
REPLACE WITH: "the balancing account"
- DELETE: Page 15, line 28: "that contains"
REPLACE WITH: "provides"
- DELETE: Page 15, line 28, "account" and "records"
- DELETE: Page 16, line 2: "(("Annual Tracking Account"))
- DELETE: Page 16, line 3: "account" and "records"
- DELETE: Page 16, lines 7-8: "(("Annual Adjustor Account"))
- DELETE: Page 16, line 8: "account" and "records"
- DELETE: Page 16, lines 10: "(("Paragraph 19(d) Balancing Account"))
- DELETE: Page 16, line 11: "account" and "records"
- DELETE: Page 16, line 12: "whether" and "is applied" and "records"
- DELETE: Page 16, line 12: "records"

DELETE: Page 16, line 13: starting with (“Surcharge Account”) through line 14, ending with “separate schedules”.

DELETE footnote 16 --Page 16, line 17 and lines 27&28.

DELETE: Page 16, lines 18-20.

REPLACE WITH:

“The Plan of Administration as proposed by the Parties is consistent with Decision No. 67744. For purposes of clarification, the Plan will be modified to require that APS provide four specific schedules related to the single balancing account, as described herein. In addition, interest will accrue on any under-collected or over-collected balance.”

DELETE: Page 19, line 13: “the accounts created herein as well as”

DELETE: Page 19, lines 15-28

DELETE: Page 20, lines 1-9

REPLACE WITH:

“The record reflects that the continued high cost of natural gas and of purchased power, as well as increases in the costs of other fuels, has resulted in a significant under-collection of power supply costs by APS since April 1, 2005. Despite a hedging program by the Company, this large under-collection occurred because the base fuel cost figure adopted by Decision No. 67744 was premised on 2003 fuel and purchased power prices and because marginal power costs are significantly higher than average power costs, thus increasing total fuel and purchased power costs as sales increase. There is nothing in the Settlement Agreement or Decision No. 67744 that prevents APS from requesting or the Commission from implementing a surcharge prior to the first scheduled PSA adjustment in April 2006. The evidence presented in support of Company’s requested \$80 million PSA surcharge was convincing, was supported by Commission Staff, and was unopposed by any Party or consumer group, and should, therefore, be granted.”

DELETE: Page 23, line 18: “Paragraph 19(d)”

DELETE: Page 23, line 20: “Paragraph 19(d)”

DELETE: Page 23, line 24: “Paragraph 19(d)”

DELETE: Page 23, line 26- line 27, starting with “and the current”

DELETE: Page 23, line 28

REPLACE WITH:

“The proposed PSA surcharge is reasonable, consistent with the provisions of Decision No. 67744 and is in the public interest, and is therefore granted.”

DELETE: Page 24, lines 3-6

DELETE: Page 24, line 10 : "Annual Tracking Account"
REPLACE WITH: "all under-recovered or over-recovered balances"

DELETE: Page 24, line 26
REPLACE WITH:

"The proposed PSA surcharge tariff schedule is approved, and will be reflected for bills rendered on or after February 1, 2006.

DELETE: Page 25, lines 10-11
REPLACE WITH:

"IT IS FURTHER ORDERED that Arizona Public Service Company's application for a surcharge is granted, as the proposed PSA surcharge is reasonable, consistent with the provisions of Decision No. 67744 and is in the public interest.

IT IS FURTHER ORDERED that the requested PSA surcharge of \$.001416 per kWh shall be effective on bills rendered on or after February 1, 2006."

Make conforming changes as necessary.

ALTERNATIVE PROPOSED APS AMENDMENT NO. 1

ADD: Page 12, line 16, after "none is allowed."

"Yet, nothing in this Decision would prohibit APS from filing for a surcharge prior to the implementation of the adjustor, so long as the effective date of such a surcharge was not prior to the implementation of the adjustor."

DELETE: Page 14, line 1: "and capped the balancing account to \$100 million"
REPLACE WITH: "required action by APS before the balancing account reaches \$100 million"

DELETE: Page 14, line 18: "at the end of the year"
REPLACE WITH: "under the mechanism,"

DELETE: Page 14, line 18: "that year's"
REPLACE WITH: "annual"

DELETE: Page 14, line 23: "after the adjustor rate is set"

DELETE: Page 15, line 23: "annual tracking mechanism"
REPLACE WITH: "the balancing account"

DELETE: Page 15, line 28: "that contains"
REPLACE WITH: "provides"

DELETE: Page 15, line 28: "account" and "records"

DELETE: Page 16, line 2: "(("Annual Tracking Account"))"

DELETE: Page 16, line 3: "account" and "records"

DELETE: Page 16, lines 7-8: "(("Annual Adjustor Account"))"

DELETE: Page 16, line 8: "account" and "records"

DELETE: Page 16, line 10: "(("Paragraph 19(d) Balancing Account"))"

DELETE: Page 16, line 11: "account" and "records"

DELETE: Page 16, line 12: "whether" and "is applied" and "records"

DELETE: Page 16, line 13: "(("Surcharge Account"))" through line 14, ending with "separate schedules"

DELETE Footnote 16: Page 16, line 17 and lines 27&28.

DELETE: Page 16, lines 18-20
REPLACE WITH:

“The Plan of Administration as proposed by the Parties is consistent with Decision No. 67744. For purposes of clarification, the Plan will be modified to require that APS provide four specific schedules related to the single balancing account, as described herein. In addition, interest will accrue on any under-collected or over-collected balance.”

DELETE: Page 19, line 13: “”the accounts created herein as well as”

DELETE: Page 19, line 16, after “available”
REPLACE WITH:

““after the implementation of an adjustor, therefore the implementation of a surcharge prior to April 1, 2006 is premature. However nothing in the Decision either prohibits the filing of an application requesting a surcharge prior to the implementation of an adjustor, or prohibits the Commission’s approval of such a surcharge, so long as the surcharge effective date is not prior to the adjustor implementation date. Since APS could request a surcharge to be effective April 1, 2006, and given the current state of under-recoveries in the balancing account, we will treat the Company’s application in this docket as a request for such a surcharge, which will be granted with the effective date of April 1, 2006. Furthermore, the Company must take this approved surcharge into account when calculating its annual PSA adjustor for 2006.”

DELETE: Page 19, lines 17 – 28

DELETE: Page 20, lines 1-9.

DELETE: Page 23, line 18: “Paragraph 19(d)”

DELETE: Page 23, line 20: “Paragraph 19(d)”

DELETE: Page 23, line 24: “Paragraph 19(d)”

DELETE: Page 23, lines 26 – 27, starting with “and the current”

DELETE: Page 23, line 28
REPLACE WITH:

“The proposed PSA surcharge is reasonable, consistent with the provisions of Decision No. 67744 and is in the public interest, and is therefore granted, effective on bills rendered on or after April 1, 2006.”

DELETE: Page 24, lines 3-6

DELETE: Page 24, line 10: "Annual Tracking Account"
REPLACE WITH: "all under-recovered or over-collected balances"

DELETE: Page 24, line 26.
REPLACE WITH

"The proposed PSA surcharge tariff schedule is approved, and will be reflected for bills rendered on or after April 1, 2006.

DELETE: Page 25, lines 10-11
REPLACE WITH:

"IT IS FURTHER ORDERED that Arizona Public Service Company's application for a surcharge is granted, as the proposed PSA surcharge is reasonable, consistent with the provisions of Decision No. 67744 and is in the public interest.

IT IS FURTHER ORDERED that the requested PSA surcharge of \$.001416 per kWh shall be effective on bills rendered on or after April 1, 2006."

Make conforming changes as necessary.

PROPOSED APS AMENDMENT NO. 2

DELETE: page 15, lines 8-19

REPLACE WITH:

“The issue of the \$776.2 million annual fuel and purchased power ‘cap’ adopted in Decision No. 67744 was discussed during this hearing. Subsequently, APS has filed an Application seeking, in part, to remove that ‘cap.’ Until we have had an opportunity to consider that request, it is reasonable that APS should be permitted to continue to defer fuel and purchased power costs above that ‘cap.’ It was never our intent that the ‘cap’ create automatic disallowances of cost irrespective of the Company’s efforts to contain fuel and purchased power costs or its compliance with our stated desire that APS file another general rate proceeding in the near future to re-examine, among other issues, the \$776.2 million ‘cap’.”

ADD: New Finding of Fact No. 33 and renumber Finding of Facts accordingly

“33. The issue of the \$776.2 million annual fuel and purchased power ‘cap’ adopted in Decision No. 67744 was discussed during this hearing. Subsequently, APS has filed an Application seeking, in part, to remove that ‘cap.’ Until we have had an opportunity to consider that request, it is reasonable that APS should be permitted to continue to defer fuel and purchased power costs above that ‘cap.’ It was never our intent that the ‘cap’ create automatic disallowances of cost irrespective of the Company’s efforts to contain fuel and purchased power costs or its compliance with our stated desire that APS file another general rate proceeding in the near future to re-examine, among other issues, the \$776.2 million ‘cap’.”

ADD: New Ordering paragraph on page 25

“IT IS FURTHER ORDERED that APS may continue to defer fuel and purchased power costs in excess of the \$776.2 million ‘cap’ referenced in Decision No. 67744 until this issue has been further examined in Docket No. E-01345A-05-0816.

Make conforming changes as necessary.