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April 10, 2006

Docket Control
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, Arizona 85007

Re: Post-Hearing Brief of Phelps Dodge Mining Company and Arizonans for Electric Choice and Competition -- Docket No. E-01345A-06-0009

Dear Sir/Madame:

You will find enclosed the original and 13 copies of the Post-Hearing Brief of Phelps Dodge Mining Company and Arizonans for Electric Choice and Competition and Cover Sheet therefor for filing in Docket No. E-01345A-06-0009. Also enclosed is one additional copy for conformation with the date of filing and return to the undersigned in the envelope provided.

Thank you for your assistance.

Very truly yours,

Mary Bollington

Mary Bollington
Secretary to C. Webb Crockett

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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR AN EMERGENCY INTERIM RATE INCREASE AND FOR AN INTERIM AMENDMENT TO DECISION NO. 67744.	Docket No. E-01345A-06-0009 **POST-HEARING BRIEF OF PHELPS DODGE MINING COMPANY AND ARIZONANS FOR ELECTRIC CHOICE AND COMPETITION**

Phelps Dodge Mining Company and Arizonans for Electric Choice and Competition (hereafter collectively "AECC") hereby submit their Post-Hearing Brief ("Brief") in the above-captioned matter.

I. INTRODUCTION

This Brief will first address issues concerning the Arizona Corporation Commission's ("Commission") legal authority to grant emergency rate relief for prospective costs. It will then address the notice requirements of A.R.S. § 40-252, that must be met to enable the Commission to amend or modify Decisions Nos. 67744 and 68437. Finally AECC's position will be set forth with respect to its recommendation concerning the amount of the increase in emergency interim revenues that should be granted to Arizona Public Service Company ("APS"), and how that increase should be allocated among customer classes.

II. LEGAL ISSUES

A. <u>Propriety of Emergency Interim Rate Relief for Prospective Costs.</u>

The Commission's authority to grant emergency interim rate relief is part of its constitutional ratemaking authority, which is plenary and exclusive. Ariz. Const. Art. 15, Section 3; Arizona *Corp. Comm'n v. State ex rel Woods*, 171 Ariz. 286, 830 P.2d 807 (1992); *Ariz. Corp. Comm'n v. Superior Court*, 107 Ariz. 24, 480 P.2d 988 (1971). In *Scates v. Arizona Corp. Commission*, 118 Ariz. 531, 578 P.2d 612 (1978), the Arizona Court of Appeals set forth three conditions that must be met for the Commission to grant interim rate relief: 1) the existence of an emergency, 2) the posting of a bond sufficient to guarantee refunds to ratepayers if such interim rates are later found to be excessive, and 3) a final determination by the Commission of the just and reasonableness of the interim rates after finding the fair value of the utility's property. *Id.* at 535, 616. These prerequisites to interim rate relief were later confirmed in *Residential Utility Consumers Office v. Arizona Corp. Comm'n*, 199 Ariz. 588, 20 P.3d 1169 (2001).

The primary determination that the Commission must make in emergency rate applications involves whether an "emergency" actually exists. According to Arizona Attorney General Opinion No. 71-17, an emergency exists when one or all of the following conditions occur: 1) when sudden change brings hardship to a utility; 2) when a utility becomes insolvent; and/or 3) when the condition of a utility is such that its ability to maintain service pending a formal rate determination is in serious doubt. Op. Att'y Gen. 71-17; *see also In the Matter of Sabrosa Water Company Application for Emergency Interim Rate Relief*, Decision No. 67990 (July 18, 2005). However, this list was not intended to define the range of conditions upon which the Commission could grant emergency interim rate relief. The Attorney General viewed the Commission as vested with "broad and exclusive legislative power to choose the modes by which it establishes rates" and to "avail itself of concepts and procedures which are devised from time to time to permit effective utility regulation . . . ." *Id.* at 45. Consistent with its broad authority, the Commission has granted emergency interim rate relief – since the year 2000 – not only in situations where *only* historical costs were evaluated, but also in situations where prospective costs threatened to severely impact the utility in a negative way. *See Sabrosa Water Company*, Decision No. 67990 (July 18, 2005) [interim rates granted to correct water capacity and quality problems]; *Pine Water Company*, Decision No. 65914 (May 16, 2003) [interim surcharge granted to recover future water hauling costs]; *Thim Utility Co.*, Decision No. 62651 (June 13, 2000) [interim surcharge to recover costs associated with purchasing water on a going-forward basis].

Likewise, APS is seeking emergency interim rate relief to recover future expenses associated with purchased power and fuel costs, subject to refund, in order to avoid a further credit downgrade, which would have a substantial negative consequence for both APS and its customers.

Arizona law, and Commission precedent, support the conclusion that the Commission has sufficient authority to grant emergency interim rate relief when prospective costs are considered part of the circumstances that warrant an emergency.

B. <u>Amending or Modifying Decisions Nos. 67744 and 68437.</u>

As a matter of law, the Commission must follow the procedure set forth in A.R.S. § 40-252 prior to rescinding, altering or amending a prior decision. This involves providing notice – and an opportunity to be heard as upon a complaint – to the affected utility as well as Intervenors. *See Gibbons v. Ariz. Corp. Comm'n*, 95 Ariz. 343, 346, 390 P.2d 582, 584 (1964); *Tonto Creek Estates Homeowners Ass'n v. Ariz. Corp. Comm'n*, 177 Ariz. 49, 56, 864 P.2d 1081, 1088 (App. 1993).

In this proceeding, Staff is recommending that APS be allowed to file quarterly surcharge applications to address any actual under-recovery of fuel and purchased power costs before the next reset of its adjustor rate. Additionally, some Commissioners have

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requested that consideration be given to increasing the Power Supply Adjustor's ("PSA") 4-mills bandwidth. Incorporating these two concepts into a final order in this proceeding would require amending Decisions Nos. 67744 (2004 Rate Case) and 68437 (Application for Surcharge), and thus require proper notice pursuant to A.R.S. § 40-252.

Staff's proposal does not "augment" existing features of the PSA – it changes the timing mechanism by which the adjustor is set from an annual basis to a quarterly basis. Furthermore, increasing the 4-mills bandwidth would not be an "additional" feature to the PSA, but would substantively alter the amount of recovery that previously was capped at 4 mills.

Staff argues that the procedural requirements of A.R.S. § 40-252 have been met if the Commission decides that notice of a § 40-252 proceeding is required prior to adopting Staff's recommendation. *See* Staff Prehearing Brief at 2-4. A similar argument might also apply to the potential amendment of the 4-mill bandwidth limits currently in the PSA. AECC does not opine whether the requirements of A.R.S. § 40-252 have been met in this proceeding with reference to the Staff's proposal and increasing the 4-mill bandwidth, but opines only that the Commission is required to provide the requisite notice and opportunity to be heard to the affected utility (APS) and intervenors in Decisions Nos. 67744 and 68437.

III. AECC RECOMMENDATIONS

A. <u>AECC Recommends That the Commission Approve an Emergency Interim Rate Increase Funded Through an Equal-Percentage Surcharge That Is Sufficient To Permit APS To Attain An FFO/Debt Ratio of 18 Percent in 2006.</u>

In light of rising fuel and purchased power costs, the recent credit downgrade experienced by APS, and the outlook for the Company's FFO/Debt ratio in the coming year, it is prudent to provide emergency relief to APS to avoid a further credit downgrade.

[Higgins Direct at 5.] The need for prompt Commission action is underscored by the fact that, on December 21, 2005, Standard & Poor's ("S&P") downgraded APS's credit ratings from "BBB" to "BBB-," the absolute lowest investment grade credit rating. [Brandt Rebuttal at 14.] A further downgrade to "junk" status would have substantial negative consequences for both APS and its customers – an outcome that would add appreciably to the future cost burden faced by Arizona energy consumers. Of immediate concern is the fact that the FFO/Debt ratio projected for APS in 2006 is well below S&P guidelines for investment grade debt, an indication that there is a material risk that a further downgrade will ensue absent emergency action. [Brandt Rebuttal at 33-35].

AECC recommends that the Commission provide the necessary relief in this emergency proceeding to avoid a further downgrade without placing an undue burden on customers. This result is most effectively and fairly accomplished by providing an emergency rate increase that will allow APS to achieve an FFO/Debt ratio of 18 percent in 2006, funded in a manner that requires each customer to shoulder an equal-percentage burden. [Higgins Direct at 6, 14].

Although there are a number of important credit metrics considered by rating agencies, the one that is most critical to target at this time to avoid a further credit downgrade of APS is the FFO/Debt ratio. [Brandt Rebuttal at 11.] S&P has recently changed APS's business profile to 6, a rating for which S&P guidelines indicate a FFO/Debt ratio in the range of 18 to 28 percent. [Brandt Affidavit at 3.] In 2005, APS's FFO/Debt ratio was 14.8 percent, significantly below this range. [Brandt Rebuttal, Attachment DEB-1.] Absent emergency action, but assuming complete approval of APS's pending surcharge applications, the Company's FFO/Debt ratio is projected to be no greater than 15.9 percent in 2006. [APS Exhibit No. 19A.] This projection is an important indicator that APS faces a material risk of a credit downgrade unless emergency action is taken.

B. AECC Recommends That the Commission Adopt a 7.7-Percent Emergency Interim Surcharge on the Base Rates of All APS Customers Effective May 1, 2006, To Allow APS To Attain an FFO/Debt ratio of 18 Percent in 2006. [Higgins Direct at 3-4, 12; AECC Exhibit No. 7, page 2, line 39.]

AECC recommends that this emergency interim surcharge remain in effect until superseded by new rates established pursuant to the general rate proceeding. This action would increase APS's revenues by $126 million in 2006. AECC's calculation assumes that the Step I PSA Surcharge requested by APS on February 2, 2006, is also implemented on May 1, 2006, an action that AECC believes is appropriate under the PSA mechanism. [Higgins Direct at 7-8.]

The impact on customers of the AECC proposal is relatively straightforward: it would be a 7.7-percent increase on base rates for all customers. When we take into consideration that current *total* rates include various surcharges, the impact of a 7.7-percent *base*-rate increase on total rates is slightly less than 7.7 percent, i.e., 7.1 to 7.4 percent, depending on customer class and usage. [APS Exhibit No. 22.][1]

AECC's conclusion that an 18.0-percent FFO/Debt ratio can be achieved with a $126 million increase is conservative, in that it assumes that APS's debt levels do not decrease as emergency revenues are collected. [Higgins Direct at 10; AECC Exhibit No. 7, p. 3.] If, in the alternative, a projected reduction in APS debt is considered in the denominator of the FFO/Debt ratio, adopting AECC's emergency rate proposal actually results in an FFO/Debt ratio of 18.2 percent. [AECC Exhibit No. 7, page 3, line 50.] Further, should the Commission choose to target an 18.0-percent FFO/Debt ratio that is less conservative than AECC's – that is, one that takes account of projected reductions in

[1] APS Exhibit No. 22 shows the impact of the recommended increase of 5.3 percent applied to base rates as proposed in AECC Witness Higgins's Surrebuttal Testimony as having an impact of 4.9 to 5.1 percent on total rates. At a higher equal percentage increase on base rates, i.e., 7.7 percent, the impact on total rates is proportionate, i.e., 7.1 to 7.4 percent.

APS debt levels – this outcome can be achieved with an emergency increase of $117 million, funded through a 7.2-percent surcharge on the base rates of all customers effective May 1, 2006. [AECC Exhibit No. 7, page 4, line 72.] AECC notes this option in the interest of providing a complete record for the Commission's consideration; AECC's recommended course of action remains the more conservative approach (from the standpoint of avoiding a downgrade) of adopting a 7.7-percent surcharge, as discussed above.

AECC's determination that it requires a $126 million increase to reach a FFO/Debt ratio of 18 percent was reached after several steps. AECC's initial recommendation – which was also $126 million – was calculated based on information provided in APS's direct case and data responses. However, in its Rebuttal Testimony, APS reported that it would experience a net fuel cost reduction of $39 million relative to the fuel costs the Company had projected in its direct case [Ewen Rebuttal at 3], and at hearing it was determined that the amount of this decrease in calendar year 2006 would be $41 million. [Ewen, Tr. at 1485.] In response to this new information, AECC Witness Higgins testified in his Surrebuttal Testimony that any net fuel cost reduction experienced by APS in 2006 could be used to reduce AECC's recommended increase of $126 million dollar-for-dollar. [Higgins, Tr. at 899.] However, APS later provided further testimony that the net cost *increase* associated with an extended Palo Verde outage would *also* be $41 million, effectively canceling out the $41 million net fuel cost savings reported by APS Witness Ewen. [Brandt, Tr. at 1925.] With this most recent change in information, it is necessary for AECC to readjust its rate increase recommendation back to $126 million in order to retain a projected FFO/Debt ratio of 18 percent in 2006. [AECC Exhibit No. 7, p. 1, line 13.]

AECC notes that accounting for the extended Palo Verde outage costs in the FFO/Debt ratio does not constitute recovery of those costs, nor does it constitute a *de* *facto* prudence determination. Rather, the emergency surcharge proposed by AECC would flow to the PSA Tracking Account as a credit against only those costs found to be prudent by the Commission, while *simultaneously* improving the Company's FFO. Thus, although the extended Palo Verde outage costs have an impact on the amount of emergency relief needed to reach the FFO target, the emergency relief provided under the AECC proposal does not directly recover those costs, but is credited against other PSA costs that would otherwise be recoverable from customers at a later date.

C. **<u>The Only Appropriate Rate Design for an Emergency Increase Is an Equal-Percentage Increase for All Customer Groups</u>.**

The flat, cents-per-kWh design of APS's proposed interim surcharge is not reasonable in the context of an emergency filing. A flat kWh charge causes disparate impacts on different customer groups, with high-load-factor E-34 customers experiencing percentage increases that are 70 percent higher than the system average. In the context of an emergency rate filing, with its limited record and restricted opportunity for cost-of-service analysis, it is not appropriate to levy disproportionate increases on different customer groups. [Higgins Direct at 14.]

Although the APS proposal can be characterized as an increase of 10.9 percent over pre-PSA rates, the design of the Company's proposal would actually raise rates for many industrial customers by as much as 18.5 percent, resulting in a significant negative impact on Arizona businesses. [Higgins, Tr. at 930-31.] As APS Exhibit No. 22 indicates, the cumulative impact on an <u>average</u> industrial customer of all the rate increases either adopted or currently proposed by APS is over 41 percent, as measured from April 2005. For high-load-factor industrial customers, the impact is significantly higher – in excess of 52 percent. For industrial customers, the looming cumulative increase is of crisis proportions. [Higgins, Tr. at 930-31.] This specter contrasts with APS's projections for small E-32 customers, those with demands under 20 kW, who are facing a much more

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modest cumulative increase of about 15 percent. [APS Exhibit No. 22.] A flat kWh emergency surcharge contributes to these disproportionate burdens between customers.

AECC has identified six instances in which state regulatory commissions have increased base electric rates on an interim basis during 2004-05. In four of the cases, the state regulatory commissions adopted equal-percentage increases. Such equal-percentage increases are typical, and hardly surprising. Absent a record to properly determine that various customer groups should bear different burdens, it is the only reasonable approach to spreading an interim rate increase. [Higgins Direct at 17.]

Even though increased fuel and purchased power costs are important contributors to APS's financial duress, we cannot assume that the cost impacts that APS is experiencing translate into simplistic kWh impacts on all kWh. For example, it is clear that APS's increased fuel and purchased power expenses are not uniform across all seasons and times of use. Simply allocating these costs on a kWh basis, as APS has done, assumes that a kWh consumed in the middle of the night in April has the same cost responsibility for mitigating APS's emergency as a kWh consumed in the heat of a July afternoon. This is clearly not the case. Consequently, it does not follow that the most appropriate interim rate design would be a flat kWh charge levied on all kWh – particularly given the magnitude of the increase and the fact that significant groups of customers would experience rate impacts that are 70-percent greater than the average under such an approach. [Higgins Direct at 19.]

Further, the proposed emergency increase is associated with a general rate case filing, and is heavily colored by the potential cost consequences to customers with respect to APS's future cost of capital if emergency relief is not provided. Thus, the emergency filing incorporates issues that have across-the-board cost implications, which is suggestive on its face of a proportionate cost burden. [Higgins Direct at 18-19.] The proper allocation of any fuel and purchased power cost increases experienced by APS remains to be determined in the general rate case.

If, despite this weight of evidence, the Commission elects not to adopt an equal-percentage increase on all customers, AECC requests that the Commission consider the following compromise that incorporates elements of both rate design proposals. The first step of the compromise would be to allocate the emergency amounts to be recovered to both Residential customers and Non-Residential customers as a whole on a cents-per-kWh basis as APS has proposed. Next, the emergency surcharge on Residential customers would be determined on a flat cents-per-kWh basis, again as APS has proposed. Finally, the emergency increase allocated to Non-Residential customers would be recovered through an equal-percentage surcharge on all Non-Residential customer base bills as AECC has proposed. Under such a compromise, Residential customers would pay the same charge as they would under the APS rate design, while Non-Residential customers would each pay an equal-percentage surcharge. While the compromise would forego the merits of a proportionate increase for all customers, it would eliminate, at least, the disparity in percentage impact across Non-Residential customers, by ensuring that each Non-Residential customer bears a proportionate burden in funding the emergency increase.

IV. APS'S PROPOSAL TO ESTABLISH A NEW BASE ENERGY RATE IN THIS EMERGENCY PROCEEDING SHOULD BE REJECTED AS THAT WOULD ALLOW APS TO AVOID HAVING TO ABSORB ITS 10-PERCENT SHARE OF THE COST DIFFERENTIAL BETWEEN THE CURRENT BASE ENERGY RATE AND ITS PROPOSED NEW BASE ENERGY RATE.

The PSA mechanism assigns 90 percent of the difference between the base cost of energy and the actual cost of energy (as defined in the Plan of Administration) to the PSA Tracking Account to be collected from customers.[2] The remaining 10 percent of this

[2] If actual costs are less than base costs, 90 percent of the differential is refunded to customers. However, that scenario is far from the case in this proceeding.

differential is absorbed by APS. As discussed in Decision No. 67744 [p. 16], this sharing mechanism was intended to provide APS an incentive to effectively manage its fuel costs, even though the Commission views the incentive as insufficient for that purpose.

Changing the base energy rate in this proceeding would allow APS to avoid having to absorb its 10-percent share of the cost differential between the current base energy rate and its proposed new base energy rate. [Higgins Direct at 12-13, Tr. at 971.] The proper forum for adjusting the base energy rate is a general rate case, not an emergency proceeding. [Higgins, Tr. at 965-66.] Rather than change the base energy rate in this emergency proceeding, the base energy rate should remain at the level established in the last general rate case, and any revenues collected from the emergency surcharge should be applied as a credit against the PSA Annual Tracking Account. In this way, the emergency surcharge would be treated as a credit against the 90-percent cost-share assignable to customers, with the remaining 10 percent assigned to APS per the PSA mechanism. [Higgins Direct at 13.] This approach also ensures that customers receive full credit against their future PSA obligation for any emergency revenues provided as a result of this proceeding. A new base energy rate would then be established in the upcoming general rate case.

V. AECC POSITION ON OTHER PROPOSALS

A. <u>AECC Recommends Against Adoption of the APS Proposal.</u>

AECC disagrees with the APS revised proposal to levy an emergency surcharge of $.008676 per kWh, for the reasons argued above.

In brief:

- The APS proposal would raise rates more than is necessary to avoid a downgrade, placing an undue burden on customers;
- By establishing a new base energy rate in this emergency proceeding rather than in the upcoming general rate proceeding, the APS proposal would

unreasonably allow APS to avoid its 10-percent cost-share of the difference between the base energy rates approved in Decision No. 67744 and its new proposed base energy rate. This change would place an undue cost burden on customers under the terms of the PSA mechanism.

- The flat kWh charge in the APS proposal would place an unreasonable and disproportionate burden on large commercial and industrial customers, in particular, customers with high load factors. Such customers would face a rate increase in excess of 18 percent from the APS emergency increase alone, while facing a prospective cumulative increase in excess of 52 percent from the various approved and requested APS rate increases, as measured from April 2005. The rate design of the APS proposal contributes to this problem.

B. <u>AECC Recommends Against Adoption of the Staff Proposal.</u>

AECC disagrees with the Staff proposal to levy quarterly surcharges under the PSA mechanism. The Staff proposal has the following disadvantages:

- By delaying emergency recovery until the third quarter of 2006, the Staff proposal fails to provide timely relief, increasing the risk of a credit downgrade.
- By implementing new surcharges on a quarterly basis, the Staff proposal would exacerbate the problem of APS's increasingly frequent rate increases. Further, the "pancaking" of successive quarterly surcharges with one-year amortization periods results in the potential for significant rate spikes for customers down the road, as evidenced in APS Exhibit No. 22. This exhibit shows that by February 2007, Staff's proposal could result in a cumulative rate increase of 28 to 32.5 percent for the average E-12 customer if APS's general rate increase request is also adopted. While that latter assumption may be seriously questioned, it is significant to note that Staff's proposal results in higher residential rates in

February 2007 than either AECC's or APS's proposal when the same assumption is made.

- A program of levying quarterly surcharges of amounts that are expected to be significant, but are yet unknown, creates considerable uncertainty for customers who are attempting to budget for their electric power costs in the upcoming year.
- By levying significant surcharges on a flat kWh basis, the Staff proposal would cause a disproportionate-percentage impact on high-load-factor customers, as is the case for the APS proposal discussed above. In AECC's view, the magnitude of the impact across customers has a bearing on the reasonableness of a proposed charge. Although Staff's proposal is based on modifying the existing PSA mechanism, AECC notes that when the flat kWh rate design in the PSA mechanism was negotiated and ultimately approved, the expected magnitude of PSA charges was considerably lower than the charges that would likely result from Staff's quarterly surcharge proposal.

C. **<u>AECC Recommends Against Widening the Bandwidth of the PSA Adjustor</u>.**

Chairman Hatch-Miller has requested that parties evaluate the prospect of widening the bandwidth of the PSA Adjustor from its current cap of 4 mills per kWh. While this proposal would have the advantage of being able to address the emergency quickly, it would have the major disadvantage of causing a significant and disproportionate impact on commercial, industrial, public institution, and military customers, for the reasons discussed above regarding both the APS and Staff proposals. Consequently, AECC respectfully recommends against adoption of an expanded bandwidth proposal.

In the event this proposal is adopted, it should be noted that the compromise rate design proposed in Section III C, above, could also be used in connection with the proposal.

VI. CONCLUSION

AECC believes that an emergency rate increase is in the public interest but should be modified from what APS has proposed as follows:

- The emergency increase should be smaller than APS has requested;
- The base energy rate should not be changed until the resolution of the General Rate Case;
- The emergency surcharge should be levied on an equal-percentage basis; and
- Any revenues collected from the emergency surcharge should be applied as a credit against the PSA Annual Tracking Account.

RESPECTFULLY SUBMITTED this 10th day of April 2006.

FENNEMORE CRAIG, P.C.

By ______________________
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Attorneys for Phelps Dodge Mining Company and Arizonans for Electric Choice and Competition

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this 10th day of April 2006 to *the remaining parties of record.*

By Mary Bollington