0000049104

RECEIVED

2006 APR 11 A 9: 13

AZ CORP COMMISSION
DOCUMENT CONTROL

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

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 **CLOSING BRIEF**

GALLAGHER & KENNEDY, P.A.
2575 E. CAMELBACK ROAD
PHOENIX, ARIZONA 85016-9225
(602) 530-8000

The Arizona Utility Investors Association ("AUIA" or "Association") submits this Closing Brief on Arizona Public Service Company's ("APS") application for an emergency interim rate increase. The Association urges the Commission to take prompt and substantive action on the request.

INTRODUCTION

The evidence leaves no doubt that the consequences of either a failure to act or inadequate action would be disastrous for the state, the Company, its customers and investors—among them, many of the 6,000 members of the Association. As Mr. Brandt explained, the ten-year cumulative impact of a downgrade to junk status would be "between $625,000,000 and $1,200,000,000, depending upon the general level of interest rates and access to the capital markets by non-investment grade issuers." (APS-2, p. 5, ll. 1-3.) Ms. Diaz Cortez put it this way: "[A] downgrade to junk status would have long-term detrimental effects on the Company and its ability to serve its growing customer base... [constraining] APS' access to debt [and] ability to finance the infrastructure needed to serve its growing customer base." (RUCO-5, p. 5, ll. 13-18.) Mr. Smith, on Staff's behalf, agreed: "In addition to resulting in increased borrowing cost, such a downgrade could also impede the Company's access to credit." (S-2, p. 18, ll. 15-16.)

Detrimental effects would not stop there:

> It is clear that a non-investment junk credit rating of the local electric utility will negatively impact businesses' perceptions about Arizona. The mere perception that a utility may become unreliable, whether factually correct or not, will be enough to negatively impact economic growth in Arizona. *** If annual employment growth in Arizona were to decline by just one-tenth of 1% during the next five years, the state would lose approximately $2.6 billion in economic activity.

(Pollack Rebuttal, APS-17, p. 2, ll. 20-23 and p. 3, ll. 13-15.) In conversations with Southern California Edison and Nevada Power, Mr. Pollack confirmed that those utilities' ratings downgrades and junk status had negatively impacted business relocation and expansion decisions in their service territories (HR TR, p. 1212, 1. 14-p. 1213, 1. 2).

Mr. Getts, on behalf of Mesquite Power, et al., also warned of the "junk" downgrade consequences for the State's independent power producers and the wholesale market:

> [T]he prospect of an APS lacking in creditworthiness represents the prospect of a significant shrinking or contraction of the competitive wholesale electric market in Arizona. In turn... the number of wholesale electric suppliers willing to commit the resources necessary to participate in such a reduced market might also shrink or contract. We believe that such a result would not be in the best interest of the State of Arizona or its electric ratepayers as a whole.

(Mesquite-1, p. 4.)

Mr. Higgins, on behalf of Arizonans for Electric Choice and Competition ("AECC"), agreed with those concerns. (HR TR, p. 935, ll. 8-23.)

Finally, "it is far easier for a utility's ratings to slip down due to a financial 'ding' than for that same utility to regain its earlier status once the deficiency has been remedied." Former Michigan Public Service Commission Chairman Steven Fetter described the difficulties utilities in neighboring California and Nevada have had in attempting, but failing, to regain prior credit ratings despite sustained regulatory support and changes in those states' policies over a number of years. "My advice to utility companies, investors and regulators alike is that nothing should be taken for granted in the current investing environment." (APS-7, pp. 21-23.)

The key issue presented by APS' request is not <u>whether</u> it will recover prudently incurred costs for fuel and purchased power, but <u>when</u>. The answer is that as little risk of a downgrade as possible, with all its substantial, long-term and widespread impacts, can be tolerated. Numerous safeguards protect the ratepayer. If the amount approved is wrong or if the cost incurred is later found imprudent, Commission processes assure the customer is held harmless. The Commission, however, has no remedy for the consequences of a failure to act or insufficient action, no control over whether the downgrade will occur and, as importantly, how long its debilitating effects will linger.

I. <u>IS THERE AN EMERGENCY</u>?

There is no doubt that the Commission has both the power to grant, and the facts here justify, emergency relief. As Staff stated in its Prehearing Brief:

> The Commission's authority to grant emergency relief is part of its constitutional ratemaking authority, which has been construed as plenary and exclusive. [Citations omitted.] Staff believes that the Commission's ratemaking authority is sufficiently broad to enable the Commission to grant emergency rate relief in response to vastly different factual circumstances. When evaluating an application for emergency rate relief, <u>the primary issue should be whether such relief is necessary to protect some specific public interest</u> and not whether the specific factual allegations bear similarities to previous cases. While the issue is cast as a legal issue, it can only be resolved by an examination of the particular facts that exist at time of inquiry.

(Staff Prehearing Brief, p. 2, ll. 8-17.) (Emphasis supplied.)

Similarly, the Attorney General, in Opinion No. 71-17, discussed four possible illustrative situations which could support interim or emergency relief, but offered the same conclusion regarding the broader scope of facts which justify action: "Perhaps the only valid generalization on this subject is that interim rate relief is not proper merely because a company's rate of return has, over a period of time, deteriorated to the point that it is unreasonably low." Obviously, APS has not applied for emergency relief because of an erosion of earnings over time.

Instead, unprecedented increases primarily in the costs of natural gas and purchased power, escalated dramatically by the Gulf region hurricanes last September, have caused APS' uncollected cost deferrals to soar—far beyond expectations in April of last year when the Commission entered the rate decision and approved the PSA. For example, at the end of November 2005, delivered 2006 natural gas prices averaged 86% and 2006 anticipated purchased power prices averaged 102% over levels included in the current base fuel rate (APS-13, p. 4, ll. 1-16). Although prices have moderated somewhat in the first quarter of this year, even assuming implementation of $232 million in emergency relief and approximately $60 million more relief in PSA surcharge approvals, APS uncollected fuel costs will still total almost $87 million by the end of this year (APS-15, p. 1, ll. 13).

On December 21, 2005, Standard & Poor's Ratings Services ("S&P") abruptly dropped both the business profile of APS and Pinnacle West Capital Corp. ("PWCC") as well as their corporate credit ratings from BBB to BBB-, only one level above non-investment grade or "junk" bond status (APS-3, DEB-7, p. 1). The combined effect of both actions left the key FFO to Debt Ratio metric almost 3% below the minimum level necessary to continue APS' investment grade rating. APS filed its request for emergency relief on January 6, 2006.

Four days later, Moody's Investors Service placed the long-term ratings of APS and PWCC under review for possible downgrade (APS-3, DEB-9, p. 1). On January 30, 2006, Fitch Ratings also lowered ratings for both APS and PWCC (APS-3, DEB-10, p. 1).

Clearly, these facts coupled with the serious and long-lasting effects of a downgrade meet several of the illustrative examples in the Attorney General's opinion as well as the broader tests for emergency relief stated by both Staff and the opinion. The "sudden change" in its fuel and purchased power costs, the December/January rating agency business position and rating downgrades, current and expected deferral levels, resulting impacts on its FFO to Debt Ratio and likely drop to "junk" status have already brought and threaten much greater "hardship to the utility" and its customers. Also, as Mr. Wheeler testified, APS' ability to provide "adequate service" is likely to be adversely impacted and the Commission cannot act quickly enough on the general rate case to affect that result this year (APS-1, p. 7, ll. 7-15). The facts also support Commission action in the broader public interest consistent with Staff's position and Attorney General Opinion No. 71-17.

However, given the circumstances here, an emergency finding is not necessary depending upon the nature of the relief granted. This proceeding has been noticed for possible amendment of the Commission's prior rate decision under A.R.S. § 40-252. Several of either the parties' proposals or possible options outlined by the Commissioners themselves do not require interim rates, but instead would be augmentations or adjustments to the PSA provisions of last April's rate decision.

For example, Staff's quarterly surcharge proposal, a broadening of the 4-mill adjustor range or the use of projected cost deferrals instead of incurred costs within the PSA would not require an emergency finding. The Association believes the record fully supports such a finding, but given the broad range of possible solutions, it may not be jurisdictionally necessary.

II. THE PARTIES' PROPOSALS AND AUIA'S RECOMMENDATIONS

A. Staff and RUCO

While resisting emergency relief, Staff does agree that PSA provisions should be supplemented to allow APS to apply for quarterly adjustments beginning June 30, 2006 (Smith, S-2, pp. 25-29). At hearing, RUCO indicated that it supports the Staff proposal. The primary benefit of this position is that it does make a significant structural change to the PSA, which is regarded as weak and unreliable by the rating agencies.

However, it does have drawbacks. First, there is significant risk that it would be judged inadequate by the rating agencies because it would provide no revenue until at least September 1. Second, 2006 revenues from Staff's quarterly surcharge would still leave the FFO to Debt Ratio below investment grade requirements (APS-9) even assuming timely action on APS' approximately $60 million in additional surcharge requests. Third, there is little definition to the process of approving surcharges and no assurance as to timing of their implementation. Fourth, the proposal creates the possibility of as many as four rate increases through the end of the year.

B. AECC

AECC agrees that APS has demonstrated a need for an emergency increase:

> In light of rising fuel and purchased power costs and the recent credit downgrade experienced by APS, some emergency rate relief is warranted. Higher utility credit costs invariably have a negative impact on customers, and I believe it is prudent to provide emergency relief to the extent that it is necessary to avoid further downgrades.

(Higgins Direct, AECC-1, p. 5, ll. 2-7.)

Therefore, as the AUIA understands its supplemental exhibit, AECC proposes approximately $126 million of immediate rate relief (AECC-7, p. 1, l. 13). The benefits of this proposal are that it provides some immediate recovery of 2006 deferrals, would retain the 90/10 APS/Customer cost sharing mechanism and would limit probable 2006 rate increases to two.

However, there are disadvantages and risks associated with this approach. First, it does not make any structural change to the PSA—a key element in rating agencies' downgrade and credit watch decisions over the past few months. Second, because this would be the only "new" revenue produced in 2006, it could be judged inadequate. Third, it is precisely targeted to the lowest possible position on the FFO/Debt credit metric—leaving APS perched on the precipe of junk bond status. As Mr. Fetter pointed out, "APS would continue to languish at the edge of junk status, susceptible to any of the myriad of risks that utilities face today that could drive it below investment grade." (APS-7, p. 27, l. 22-p. 28, l. 2.)

C. <u>AUIA's Recommendations</u>

The consequences of a credit downgrade to junk status are so severe that any significant risk of a drop to junk is unacceptable. However, the Association does not believe that necessarily dictates grant of all the relief which APS has requested. A combination of approaches specifically aimed at the rating agencies' articulated concerns will moderate rate impact, address the financial emergency and allow the Commission and parties time to work on permanent solutions.

With regard to regulatory relief and financial metrics, the rating agencies have emphasized two issues which must be addressed to safeguard APS' credit rating: (1) the growing amount of unrecovered fuel cost IOUs and (2) the structural infirmities associated with the PSA. The AECC proposal addresses the former, but not the latter. The Staff recommendation addresses PSA infirmities with quarterly surcharges but provides very minimal 2006 deferral relief.

To address both issues, the AUIA recommends a blend of the two recommendations:

1. Authorize an immediate surcharge in the amount of $159 million effective May 1, 2006 with revenues collected from it credited to the PSA annual tracking account.[1] The $159 million amount consists of Mr. Higgins' $126 million recommendation plus the estimated $33 million which would be produced by Staff's recommended June 30 quarterly surcharge.

2. Modify the PSA to allow APS to apply for quarterly adjustments, beginning September 30, 2006, subject to further or different refinement in the general rate case.

3. Approve the following provisions to tighten PSA procedures and add certainty:

> (a) adjustments take effect 30 days after filing, unless Staff review raises extraordinary issues, requiring Commission approval at its next regularly scheduled Open Meeting;
>
> (b) quarterly surcharge amounts up to $50 million would be amortized over 12 months, while amounts over $50 million would be amortized over 18 months;
>
> (c) interest would accrue on all unrecovered surcharge balances;
>
> (d) Staff's recommended reporting and filing conditions would be adopted;
>
> (e) Surcharge applications would exclude costs associated with unplanned outages in excess of the Effective Forced Outage Rate used in APS' budget and in determining its normalized fuel/purchased power costs in the general rate filing; and

---

[1] AUIA believes that Mr. Higgins' recommendation of approximately $126 million includes an allowance for the $15.3 million in surcharge relief approved by the Commission at its April 5, 2006 Open Meeting in Docket No. E-01345A-06-0063. If we are incorrect in that assumption, then the Association's recommendation should be increased to $174.3 million.

(f) Staff would review excluded costs and file a recommendation within 120 days of a surcharge filing.

The Association's recommendation has a number of benefits and should eliminate most of the risk associated with a potential credit downgrade to junk status. It provides immediate relief as well as structural change to the PSA which addresses certainty and timeliness concerns going forward. It retains the cost-sharing features of the current clause. Finally, it limits possible rate increases to three.

The AUIA also finds merit in two other proposals. First, referring to APS-18, broadening the adjustor band width to 10 mills or more would also provide immediate relief, a substantive PSA structural change and would reduce possible 2006 rate increases to two. Second, referring to APS-15, the grant of $200 million of emergency relief instead of the $232 million which APS has requested would leave approximately $117 million in deferrals for collection—roughly consistent with the current 4-mill bandwidth—next February. With the exception of Commission action on the still outstanding $45 million surcharge request in Docket No. E-01345A-06-0063, this would reduce to one the number of likely rate adjustments until the Commission acts on the permanent case.

CONCLUSION

RUCO's Ms. Diaz Cortez responded that she didn't know what options the Commission would have if a downgrade occurs to deal with APS' financial condition. (HR TR, p. 1702, ll. 5-15.) The Association does know: few, if any. The climb back up the stairs from the basement is long, arduous, costly and uncertain for all. Prompt, substantive action is warranted to protect the public interest and Arizona's well-being.

RESPECTFULLY SUBMITTED this 10th day of April, 2006.

GALLAGHER & KENNEDY, P.A.

By [signature]
Michael M. Grant
Todd C. Wiley
2575 East Camelback Road
Phoenix, Arizona 85016-9225
Attorneys for Arizona Utility Investors Association

Original and thirteen copies filed the 11th day of April, 2006, with:

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Copy of the foregoing e-mailed to Hearing Division this 10th day of April, 2006.

Copies of the foregoing mailed this 10th day of April, 2006, to:

Thomas L. Mumaw
Pinnacle West Capital Corporation
Post Office Box 53999, MS 8695
Phoenix, Arizona 85072-3999

C. Webb Crockett
Fennemore Craig, P.C.
3003 North Central Avenue, Suite 2600
Phoenix, Arizona 85012

Scott Wakefield
Residential Utility Consumer Office
1110 West Washington Street, Suite 220
Phoenix, Arizona 85007

Walter W. Meek
Arizona Utility Investors Association
2100 North Central Avenue, Suite 210
Phoenix, Arizona 85004

Lawrence V. Robertson, Jr.
Munger Chadwich, P.L.C.
Post Office Box 1448
Tubac, Arizona 85646-0001

Timothy H. Hogan
Arizona Center for Law in Public Interest
202 East McDowell Road, Suite 153
Phoenix, Arizona 85004

Michael W. Patten
J. Matthew Derstine
Laura E. Sixkiller
Roshka DeWulf & Patten, P.L.C.
400 East Van Buren, Suite 800
Phoenix, Arizona 85004

Jay I. Moyes
Moyes Storey, Ltd.
1850 North Central Avenue, Suite 1100
Phoenix, Arizona 85004

Lieutenant Colonel Karen S. White
Chief, Air Force Utility Litigation Team
AFLSA/JACL-ULT
139 Barnes Drive
Tyndall AFB, Florida 32403

Nicholas J. Enoch
Jarrett J. Haskovec
Lubin & Enoch, P.C.
349 North Fourth Avenue
Phoenix, Arizona 85003

Christopher Kempley
Chief Counsel, Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

18762-2/1353777