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AZ CORP. COMMISSION
DOCUMENT CONTROL
March 1, 2002

VIA HAND DELIVERY

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

Re: *Rebuttal Testimony of Carl W. Dabelstein,
Sean R. Breen, Paul M. Flynn and William E. Avera
Citizens' PPFAC; Docket No. E-01032C-0751*

Dear Sir/Madam:

Enclosed are the original and ten (10) copies of the rebuttal testimony of Mssrs. Dabelstein, Breen, Flynn and Avera on behalf of Citizens.

Very truly yours,

GALLAGHER & KENNEDY, P.A.

By:
Michael M. Grant

MMG:bo
Attachments

Original and ten copies filed this
1st day of March, 2002, with:

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Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Arizona Corporation Commission
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March 1, 2002
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COPY of the foregoing hand-delivered
this 1st day of March, 2002 to:

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3099-0039/998643v1

CITIZENS COMMUNICATIONS COMPANY

ARIZONA ELECTRIC DIVISION

DOCKET NO. E-01032C-00-0751

REBUTTAL TESTIMONY OF CARL W. DABELSTEIN

1 **Introduction**

2 Q. Please state your name and address.

3 A. My name is Carl W. Dabelstein. My business address is 2901 North Central
4 Avenue, Suite 1660, Phoenix, Arizona 85012.

5
6 Q. Are you the same Carl W. Dabelstein that previously filed direct testimony
7 in this proceeding?

8 A. Yes, I am.

9
10 Q. What is the purpose of your testimony in this part of the proceeding?

11 A. I am submitting rebuttal testimony to portions of the direct testimonies
12 filed by Commission Staff Witness Lee Smith and RUCO Witness Richard
13 Rosen.

14
15 Q. What portions of Ms. Smith's testimony will your rebuttal testimony
16 address?

17 A. I am presenting rebuttal testimony with respect to the following areas of
18 her direct testimony:

- 19 - The use of financial hedges.
20 - The former APS power-supply agreement.
21 - Carrying costs on the PPFAC Bank balance.
22 - The effect of line losses on the requested surcharge rate.
23 - Ms. Smith's characterization of the requested surcharge rate.

24
25 Q. What portions of Mr. Rosen's testimony will your rebuttal testimony
26 address?

27 A. I am presenting rebuttal testimony with respect to the following areas of his
28 direct testimony:

29

- 1 - Resource Supply Planning
- 2 - Commission interpretation of wholesale power contracts

3

4 **Rebuttal of Smith Testimony**

5 Q. With respect to the matter of the use of financial hedges, please identify
6 the portion of Ms. Smith's testimony to which your rebuttal is directed.

7 A. At Pages 6-8, 31-34, and 42-43 of her testimony, Ms. Smith is critical of
8 Citizens for not anticipating during the early months of 2000 the high prices
9 for power in the wholesale markets that occurred during the summer
10 months of that year, and for not resorting to the use of financial hedges.
11 Moreover, beginning at Line 17 on Page 7 she states that Citizens should
12 have undertaken an assessment of market conditions, "starting no later
13 than January 2000."

14

15 Q. What is a "financial hedge"?

16 A. The concept of a "financial hedge" indicates the use of certain types of
17 financial instruments by an entity in connection with the objective of risk
18 mitigation, in this instance, the risk of volatile and higher wholesale power
19 market prices. Hedging is typically accomplished through the use of
20 derivatives. Derivatives are financial instruments that derive their value
21 from the value of other financial instruments or an "underlying" such as a
22 commodity, futures contract, stocks, bonds, currency, index, or interest
23 rate. The most frequent types of financial derivatives in the electric power
24 industry are forwards and futures contracts, options, and swaps. Thus far,
25 few state regulatory agencies have fully addressed the issue of financial
26 hedging by electric utilities under their jurisdiction.

1 Q. Do you agree with Ms. Smith's criticism of Citizens' for not using financial
2 hedges to mitigate price risk during the summer of 2000?

3 A. No, I do not agree for two key reasons. First, in justifying the use of
4 financial derivatives, there must be some reasonable expectation of
5 significant potential for volatility and spikes in the price of the underlying
6 commodity. Clearly, during late 1999 and the early months of 2000, there
7 were no significant concerns about high prices in the wholesale power
8 market being expressed by any of the key entities and institutions
9 addressing the introduction of retail competition in the State of Arizona.
10 During this period, orders and/or settlement agreements between the
11 Commission Staff, RUCO, the respective utilities and other parties,
12 providing for the commencement of retail competition by Arizona Public
13 Service, Tucson Electric Power, and Arizona Electric Power Cooperative
14 ("AEPCO") were approved by the Commission. A major concern in each
15 order or settlement was the potential for the incumbent utilities to incur
16 stranded costs (measured as the excess of embedded generation costs over
17 the expected cost of power in the wholesale markets) and how they would
18 be recovered (through a Competition Transition Charge or "CTC").
19 Intuitively, such concern about the need for, and the resulting inclusion of,
20 a customer charge for stranded generation costs in the approved
21 settlement agreements, is contrary to any expectation by the parties of
22 significant increases in the market price for power in the foreseeable future.

23
24 As an example, with respect to AEPCO, Commission Decision No. 62758
25 issued on July 27, 2000, contains the following statement at Page 24, Line
26 9:

1 *AEPCO has agreed to **Staff's recommended market***
2 ***price estimate of \$.030 per kWh in the first year***
3 *commencing July 1, 2000. (Emphasis added)*

4 Furthermore, in the Finding of Facts section of that Decision, beginning at
5 Line 12 on Page 9, the following statement appears:

6 *In the first year commencing July 1, 2000, the parties*
7 *have agreed that the AEPCO's CTC should be \$.0091 per*
8 *kWh **based on a market price of generation of \$.030***
9 ***per kWh** and generation revenue from the Distribution*
10 *Cooperatives of \$.0391 per kWh. (Emphasis added)*

11 By accepting the use of a \$.03 per kWh market price for computing the
12 CTC, this Commission Order clearly demonstrates that there was no
13 expectation by either the Staff (who was being advised by Ms. Smith
14 throughout that period) or the utility that wholesale power market prices
15 would spike as they did during the summer of 2000, even after some price
16 spikes had already materialized. Given Ms. Smith's assertion that Citizens
17 should have made an assessment of market conditions no later than
18 January 2000, it is noteworthy that the hearings in the AEPCO matter,
19 during which Ms. Smith testified supporting her \$.03 per kWh expected
20 market price, were conducted on February 28 and 29 of 2000. To place
21 that in context for this proceeding, only two months before Citizens began
22 to incur significantly higher power bills from APS, Ms. Smith was testifying
23 in support of a market price estimate that, for the period July 2000 through
24 June 2001, was \$.02 per kWh lower than Citizens' base cost of power for
25 PPFAC purposes.

26 With respect to Citizens' stranded cost application, Ms. Smith submitted
27 direct testimony on June 20, 2000, in support of a proposed settlement
28 agreement between the Company, RUCO, and Commission Staff. Beginning
29

1 at line 9 on page 7 of her testimony, in explaining a proposed reconciliation
2 process, she states the following:

3
4 *Provision 7 b limits the annual increase in the CTC to 2*
5 *mills per kWh. If the reconciliation amount would cause*
6 *the CTC to increase by more than this amount, some of*
7 *that amount must remain in the reconciliation account,*
8 ***with carrying charges.*** *Provision 7 g allows the parties*
9 *to accelerate recovery of the CTC balance if the amount*
10 *in the account exceeds \$3 million and is expected to*
11 *continue growing. **This seems to be a very unlikely***
12 ***eventuality,*** *but both Company and ratepayers are*
13 *protected by this provision. (Emphasis added)*

14 It is clear that, after several weeks of price spikes, Ms. Smith still believed
15 that market prices would remain below embedded generation costs. By
16 criticizing Citizens for not anticipating the higher prices, she is contradicting
17 her own testimony about market price expectations, and is unfairly placing
18 a standard of clairvoyance upon this Company that she failed to display
19 herself.

20 I also disagree with Ms. Smith's criticism of Citizens' for not using financial
21 hedges for a second reason. There is no guidance of any sort with respect
22 to the Commission's position on the use of financial derivatives to mitigate
23 electric price risk, how they should be accounted for, or the standards of
24 prudence that would be imposed in connection with requests for cost
25 recovery.

26 Before a utility embarks on a non-traditional course of action that will result
27 in the incurrence of new types of costs that may be significant, the
28 regulatory treatment must be known and be appropriately considered in the
29 decision-making process. To incur significant costs with no sense of how

1 such action would be judged by the regulators, or how cost recovery would
2 be achieved, would be a breach by utility management of its fiduciary
3 responsibility to the company's investors.

4
5 In its initial application in this matter, filed on September 28, 2000,
6 guidance from the Commission on the use of hedges was sought by
7 Citizens. On page 35 of that application, the following questions were
8 asked:

- 9
- 10 • Under what circumstances is the use of price hedging warranted?
 - 11 • How should utilities weigh the value of price uncertainty?
 - 12 • Should hedged energy pricing be applied to all customers
13 or only to those who select the option?
 - 14 • What limits should be imposed on ratepayer exposure to risk from
15 hedging activities?
 - 16 • What standards and criteria will be applied in judging the prudence
17 of utility hedging decisions (or decisions not to hedge)?
 - 18 • What filing requirements, if any, should apply for utility risk
19 management plans?
 - 20 • What reporting should be instituted?
 - 21 • Should hedging costs be recovered through the PPFAC or through
22 base rates?

23 Thus far, no guidance has been forthcoming.

24
25 It should also be noted that, although the concept of hedging to minimize
26 supply price risks was addressed back in 1998 by the working group
27 assembled to review the Purchased Gas Adjustment ("PGA") mechanism
28 used by the local distribution companies in the State, thus far there has
29

1 been no Commission resolution with respect to accounting issues, cost
2 recoveries, or prudence standards issues. Had the Company requested
3 such guidance "long before" September 28, as suggested by Ms. Smith on
4 Page 8 of her testimony, it is doubtful whether such information would have
5 become available and all key issues resolved before the summer of 2000,
6 given this PGA experience.

7
8 Finally, Citizens is required by both the Arizona Corporation Commission
9 and the Federal Energy Regulatory Commission ("FERC") to comply with the
10 requirements of the FERC Uniform System of Accounts ("USOA"). It was
11 not until August 10, 2001, some eighteen months after Ms. Smith suggests
12 the use of financial hedges, when the Chief Accountant of the FERC issued a
13 notice to all jurisdictional utilities containing appropriate guidelines, that
14 there was any clear indication of even how to account for derivative
15 instruments and hedging activities under the USOA.

16
17 Q. What is your conclusion?

18 A. The Commission should recognize the impracticality and unreasonableness
19 of Ms. Smith's assertion that Citizens should have purchased financial
20 hedges in early 2000, when there were no guidelines or standards of
21 performance for the Company to follow or consider and, at a time when
22 neither she, nor the other relevant stakeholders, were expecting the huge
23 run up in wholesale power prices that occurred during the summer of 2000.

24
25 Q. Please discuss your response to Ms. Smith's testimony concerning the
26 former APS power supply agreement.

27 A. At Pages 5 and 14 of her testimony, Ms Smith offers several criticisms of
28 the former APS power supply agreement, and uses those criticisms as part
29

1 of the basis for her recommended disallowance of a portion of the PPFAC
2 Bank balance. Her criticisms range from a perceived lack of clarity,
3 including arguments about terms or conditions that should have been
4 included, to inadequate billing data. This represents an unfair attack on a
5 power supply agreement that was thoroughly audited by the Commission
6 Staff and RUCO in connection with the Company's last rate case, with no
7 allegations of imprudence, omission, or ambiguity. Moreover, as more fully
8 described in the rebuttal testimony of Mr. Breen, prior to the summer of
9 2000, the contract signed with APS in 1995 produced millions of dollars of
10 cost savings that were passed on to Citizens' customers.

11
12 Q. Please explain the regulatory history of the former APS power supply
13 agreement.

14 A. The agreement was signed by the parties in early June 1995. It first came
15 before the Commission in connection with an application filed by Citizens on
16 June 10, 1995, in which the Company was requesting approval to reset its
17 PPFAC adjustor and to refund to customers an over-recovered balance that
18 had accumulated in the PPFAC Bank. In anticipation of lower power supply
19 costs under the then just signed APS power supply agreement, the
20 Company was seeking approval of a negative PPFAC adjustor. Commission
21 Decision No. 59170, issued on July 20, 1995, states on page 3 that the
22 Staff did not have the opportunity to examine the reasonableness and
23 prudence of Citizens' new contract with APS, or its impact on purchased
24 power costs in the near future. Beginning at line 27 on page 3, the Order
25 concludes that:

26 *The detailed examination of the PPFAC Bank balance,*
27 *reconciliation of the refund, and analysis of the*
28 ***purchased power contract is deferred until the***
29 ***upcoming AED rate proceeding.*** (Emphasis added)

1 Further, beginning at Line 12 on Page 4, the Order states:

2 *IT IS FURTHER ORDERED that the audit of the bank*
3 *balance and issues associated with the PPFAC refund and*
4 *reconciliation, as well as **the analysis of the purchased***
5 ***power contract with APS be deferred until the***
6 ***upcoming rate proceeding for the AED.** (Emphasis*
7 *added)*

7 Q. When did that next rate case occur?

8 A. Citizens filed the application for an electric rate increase on September 13,
9 1995. Recognizing the requirements of Decision No. 59170, the Company's
10 filing included extensive testimony on, as well as a copy of, the new APS
11 power supply contract. Through Company witnesses, Michael Mount and
12 Sylvain Lacasse, detailed information about various aspects of the new
13 agreement as well as substantial cost data was provided to the
14 Commission.

15
16 Q. What was the outcome?

17 A. The agreement was thoroughly reviewed in the rate case. Decision No.
18 59951 was issued by the Commission on January 7, 1997. There were no
19 allegations of imprudence, either by the Staff or RUCO. No one asserted
20 there were any ambiguities or a lack of clarity, or that there were features
21 that should have been added to the contract. Sample billing information
22 was also requested and provided through the discovery process, and no
23 one raised any concerns about the adequacy of billing documentation.

24
25 Interestingly, as summarized on Pages 39-40 of Decision No. 59951, as
26 part of Citizens' application, the Company offered to suspend the PPFAC
27 mechanism. That was soundly objected to by both Staff and RUCO. It was
28 clear that both anticipated significant power supply cost reductions under
29

1 the then new APS power supply contract, and thus, strongly urged the
2 Commission to maintain the PPFAC so ratepayers could reap the anticipated
3 benefits quickly. The Commission accepted that recommendation in its
4 Decision.

5
6 Q. Were there any changes to the former APS contract subsequent to Citizens'
7 last rate case?

8 A. Yes. As more fully explained by Mr. Breen, there were a few changes,
9 including a reduction of the demand charge rates. Commission Decision
10 No. 62094 issued on November 23, 1999, authorized the implementation of
11 a negative PPFAC adjustor to pass such cost savings on to customers
12 beginning in December 1999. Those amendments to the contract were
13 identified and explained to the Staff and RUCO consultants retained to
14 review Citizens' stranded cost and unbundled tariff applications during
15 portions of 1998, 1999, and early 2000. To the best of my knowledge,
16 there were no allegations of imprudence or ambiguity raised in connection
17 with those reviews.

18
19 Q. What is your conclusion with respect to Ms. Smith's criticism of the APS
20 contract?

21 A. Pursuant to specific Commission direction, the APS power supply agreement
22 signed in 1995 was thoroughly evaluated in connection with Citizens' last
23 electric rate case, with no allegations of imprudence, omissions, or
24 ambiguity raised. It is patently unfair for the Staff witness to now, more
25 than five years later, criticize the former agreement.

26
27 Q. What is Ms. Smith's position with respect to the accrual of carrying charges
28 on the PPFAC bank balance?

1 A. Ms. Smith recommends that: (a) \$7 million of the PPFAC Bank balance be
2 disallowed, (b) that \$31 million be recoverable over six years, and (c) that
3 Citizens should pursue recovery of the remaining \$49 million at the FERC.
4 On page 46 of her testimony, Ms. Smith recommends that Citizens' request
5 to accrue carrying charges on the PPFAC Bank balance be denied. She
6 characterizes such denial as "an additional penalty" for what she calls the
7 Company's lack of prudence in managing the contract.

8
9 Q. Do you agree with that recommendation?

10 A. No, I do not. That recommendation is unfair and defies economic logic. It
11 also contradicts the testimony filed by Ms. Smith in connection with the
12 proposed Citizens' stranded cost settlement agreement on which I
13 previously commented. Citizens should be allowed to accrue carrying
14 charges on all recoverable power supply costs chargeable to the PPFAC
15 Bank.

16
17 Q. Please explain.

18 A. The Commission clearly recognized the need for, and the propriety of,
19 accruing carrying charges on amounts accumulated in the PGA Bank
20 accounts of the local gas distribution companies in Arizona in its Decision
21 No. 61225 issued on October 30, 1998. The underlying economic rationale
22 is no different for balances accumulated in Citizens' PPFAC Bank account.
23 The new PGA mechanism also permits the affected gas utility to change its
24 PGA billing factor monthly, while PPFAC factor changes require formal
25 applications, hearings, and Commission approval. That alone tends to
26 produce greater accumulations of costs in the electric bank balances and
27 longer periods of recovery. There is an economic cost associated with the
28 time period between the expenditure of funds by a utility in connection with
29

1 the provision of service and the ultimate recovery of such costs from
2 customers. Whether the Commission disallows the recovery of some
3 portion of the PPFAC Bank balance, fairness and equity dictate that the
4 Company should still be allowed to accrue carrying costs on the balance
5 that is deemed to be recoverable. That is conceptually consistent with the
6 accrual of carrying charges on the special CTC accumulation account
7 provided for in Citizens' stranded cost settlement agreement previously
8 referenced herein which was supported by Ms. Smith in her testimony filed
9 on June 20, 2000.

10
11 Based on the current authorized rate of return for Citizens' Arizona Electric
12 operations, approximately \$10 million in financing costs has already been
13 incurred by Citizens in connection with the un-recovered balance in its
14 PPFAC Bank. The Company will never be able to recover any portion of
15 that amount. To continue to deny the Company the ability to accrue
16 carrying charges on the PPFAC Bank balance sought in the proceeding as
17 proposed by Ms. Smith would force the Company's investors to absorb an
18 additional \$13 million in losses.

19
20 Although the historical operation of the PPFAC mechanism has allowed
21 Citizens to recover any un-recovered power supply costs within six to
22 twelve months via a surcharge, in this instance, to avoid rate shock and
23 economic hardship for its customers, Citizens has proposed extending
24 recovery over a period of seven years. During that extended recovery
25 period, Citizens will incur many more millions of dollars in financing costs
26 associated with the PPFAC Bank balance. Ms. Smith recommends that any
27
28
29

1 recovery occur over a period of six years. To recommend recovery of
2 prudently incurred costs over six years without any allowance for carrying
3 charges defies economic logic, and sound ratemaking principles.
4

5 Utilities are allowed to charge rates based on a revenue requirement
6 reflecting the reasonable and necessary costs of providing safe, reliable
7 service plus a fair return on investment. In setting a fair rate of return,
8 regulators consider all of the relevant business and financial risks to which
9 the company is exposed. There is a perception that utilities that have cost
10 adjustment mechanisms in place have reduced business risks, and as a
11 result, they receive lower rates of return than would otherwise be granted.
12 In the case of Citizens, at the time of the last electric rate case, the PPFAC
13 mechanism had been in place for decades. There was a reasonable
14 expectation that the Company would be permitted to recover excess power
15 supply costs within a relatively short period of time, from six to twelve
16 months. The rates of return implicit in the service rates currently charged
17 to Citizens' customers simply do not adequately compensate investors for
18 the risk of deferring for a period of up to seven years, un-recovered power
19 supply costs that nearly match the total annual revenues for the entire
20 Arizona Electric Division.
21

22 Q. Please describe the Line Loss issue.

23 A. As a result of the physical properties of transmission and distribution lines,
24 greater quantities of power must be placed into the electric system than is
25 ultimately delivered to the customers' meters. This is known as "line loss."
26 In the computation of the requested PPFAC surcharge factor, Citizens used
27 the actual test year, 10.69% line loss factor reviewed and approved by the
28 Commission in setting the base cost of power at \$.05194/kWh. At Page 51
29

1 of her testimony, Ms Smith appears to be recommending that a factor of
2 9.91%, reflecting the average line losses during the past six years, be used
3 in developing the PPFAC surcharge rate.
4

5 Q. Do you agree with that assessment?

6 A. While I agree that the average line loss factor for the past six years was
7 9.91%, I believe that Ms. Smith's concerns are unnecessary, or at least
8 misplaced. Line losses are typically recognized at the time of general rate
9 cases, not PPFAC applications. Moreover, the line loss factor is just one of
10 several estimates that were used in developing the requested surcharge
11 rate. The computed surcharge also reflects estimates of monthly sales
12 levels through May 2008. The effect of the variation between projected
13 monthly sales and actual sales has a significantly greater potential effect on
14 the surcharge calculation than does the line loss factor. Moreover, there is
15 no assurance that a 9.91% loss factor is more representative of actual
16 losses to be experienced during the next seven years, or that it will produce
17 a more accurate surcharge rate, than using what the Commission has
18 already approved in base rates in Citizens' last electric rate case. It must
19 be remembered that only the actual power supply costs incurred (reflecting
20 actual, not estimated, line losses) will be charged to the PPFAC Bank, and
21 only the actual amounts recovered through base rates and the PPFAC
22 surcharge will be credited to the bank. Customers are not subject to any
23 risk of over-collection by the Company.
24

25 Q. What is your conclusion on this issue?

26 A. The Commission should recognize that the computation of a PPFAC
27 surcharge rate requires the use of several types of estimates, that there is
28 no risk of over-recovery by Citizens, and that Ms. Smith's proposed use of a
29

1 different line loss factor is unnecessary and provides no greater assurance
2 of computational accuracy.

3
4 Q. What is the issue concerning Ms. Smith's characterization of the requested
5 surcharge rate?

6 A. Beginning on page 52 of her testimony, Ms. Smith characterizes the
7 requested surcharge as an "automatic reconciliation factor." That suggests
8 to me that she believes the surcharge rate we are requesting is subject to
9 some type of periodic adjustment. That characterization is not correct.

10
11 Q. Please explain.

12 A. Citizens is requesting Commission approval of a two-part, \$.028149 per
13 kWh PPFAC surcharge factor that will remain constant throughout the
14 recovery period, which we propose to be the term of the new power supply
15 agreement with APS.

16
17 The first component of the surcharge is \$0.015610 per kWh, the amount
18 that will increase the current base rate recovery level of \$.05194 per kWh
19 to a level reflective of the costs under the new APS contract, including the
20 effect of line losses, plus the amounts to be paid to the WAPA for
21 transporting the power into our service territory. By equating current costs
22 with current cost recovery, future variations in the PPFAC Bank balance due
23 to imbalances between costs and recoveries will be virtually eliminated.

24
25 The second component of the requested surcharge is \$0.012539 per kWh,
26 the fixed rate required to extinguish the \$87 million PPFAC Bank balance
27 existing at the time our revised application, plus carrying charges computed
28 at the interest rate paid on customer deposits.

1 To the best of my knowledge, the use of a surcharge factor that is constant
2 over the allowed recovery period is consistent with the manner in which the
3 PPFAC mechanism has operated throughout its history. Moreover, the use
4 of a constant surcharge produces the rate stability that the Commission has
5 identified as a desirable ratemaking goal.
6

7 **Rebuttal of Rosen Testimony**

8 Q. With what portions of Dr. Rosen's testimony do you disagree?

9 A. At several locations in his testimony Dr. Rosen makes statements or
10 recommendations which I believe indicate either a lack of understanding of
11 the Commission's resource planning process or incorrect assumptions about
12 its jurisdictional authority over wholesale power contracts.
13

14 Q. Please explain.

15 A. On page 8 of his testimony, Dr. Rosen states that "Citizens should also
16 have requested that the ACC review the prudence of APS' past generation
17 supply activities, and its future supply plans, since these are regulated by
18 the ACC." On page 12, he further states "The issue of supply planning for
19 APS is, in my opinion, primarily a regulatory issue for the ACC because the
20 FERC does not usually regulate supply planning, even for the provision of
21 wholesale contracts." These assumptions about the Commission's Resource
22 Planning process that are incorrect, or at least fail to consider the current
23 state of the Commission's IRP Rule.
24

25 Q. What is the current state of the Commission's IRP Rule?

26 A. The ACC adopted Rule R14-2-701 for utility integrated resource planning
27 ("IRP") in Decision No. 56180, issued in October 1988, as amended in
28 Decision No. 56313 in January 1989. The Rule required electric utilities in
29

1 Arizona with generating facilities to submit a resource plan every three
2 years, and historical data every year. The affected utilities, APS, TEP,
3 AEPCO, and Citizens filed their resource plans and historical reports
4 regularly through the 1995 reporting period. About the same time, the
5 Commission was well into its inquiry into Electric Restructuring. A number
6 of parties began to question the necessity for, or propriety of a public
7 resource planning process, such as had been administered by the ACC. In
8 connection therewith the Commission Staff began a reassessment of the
9 requirements under existing IRP Rule. In the meantime, the Commission
10 stayed the Rule indefinitely.

11
12 In August 1997, a Staff Report was issued containing its recommendations
13 on the Rule. After considering comments on the Staff Report by the
14 various interested parties, on August 29, 1997, the Commission issued
15 Decision No. 60385 effectively suspending the IRP Rule, except for the
16 portion requiring the annual reporting of historical data.

17
18 Based on the foregoing, there simply is no current way to accomplish Mr.
19 Rosen's recommendation. There is no on-going IRP program at the ACC. I
20 do not see a way that the Commission could have, or would have, been
21 willing to consider Citizens' request, perform an investigation, and issue any
22 findings, as he suggests.

23
24 Q. Do you disagree with Dr. Rosen's testimony on jurisdictional authority?

25 A. Yes. On page 8, he opines that Citizens should have filed a request at the
26 ACC to get the ACC's interpretation of the items in the former APS contract
27 that were in dispute. That assertion is repeated on page 9 with the addition
28 that such request should have been made in the fall or winter of 2000-

1 2001, and the position is again repeated at page 11. He is critical of
2 Citizens for not making such a request.

3
4 Q. Why do you disagree?

5 A. I fail to see the basis on which Dr. Rosen makes such a recommendation.
6 Wholesale power supply agreements are not within the direct regulatory
7 purview of the ACC. To the best of my knowledge, there is no vehicle by
8 which to request such a determination. Moreover, assuming for discussion
9 purposes that such an analysis were to be performed by the Commission or
10 its Staff, I fail to see any regulatory weight that may be given to those
11 findings, irrespective of what they might be.

12
13 Q. What is your conclusion?

14 A. The Commission should reject Dr. Rosen's assertion that it had the
15 authority or ability to assess the prudence of APS' resource supply plans for
16 wholesale customers, and that Citizens should have applied to the ACC for
17 an interpretation of a wholesale power supply agreement. Such
18 recommendations are unfounded, impractical, or require regulatory
19 oversight beyond the Commission's jurisdictional authority.

20
21 Q. Does this conclude your rebuttal testimony?

22 A. Yes it does.
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**CITIZENS COMMUNICATIONS COMPANY
ARIZONA ELECTRIC DIVISION
DOCKET NO. E-01032C-00-0751
REBUTTAL TESTIMONY OF SEAN R. BREEN**

1 **INTRODUCTION**

2 Q. Please state your name and business address.

3 A. My name is Sean R. Breen. My business address is Citizens
4 Communications Company, 1300 South Yale Street, Flagstaff, Arizona
5 86001.

6
7 Q. Are you the same Sean R. Breen who previously submitted direct testimony
8 in this case?

9 A. Yes, I am.

10
11 Q. What is the purpose of your rebuttal testimony?

12 A. The purpose of my rebuttal testimony is to respond to the assertions about
13 Citizens' management of its power supply made by Dr. Richard A. Rosen on
14 behalf of the Residential Utility Consumer Office ("RUCO") and Lee Smith on
15 behalf of the Arizona Corporation Commission ("ACC") Staff in their
16 respective direct testimonies.

17
18 Q. Please summarize your testimony.

19 A. My rebuttal testimony demonstrates that, contrary to the assertions of the
20 Staff and RUCO witnesses, Citizens:

- 21 • prudently managed its power supply contracts with APS, producing
22 substantial benefits for customers;
- 23 • could not have reasonably foreseen the magnitude of power cost
24 increases experienced in the summer of 2000;
- 25 • strenuously negotiated to modify its contract with APS prior to the
26 summer of 2000 and could have put in place a more economical
27 contract but for a reversal by APS during negotiations that could not
28 have been anticipated;

- 1 • took additional focused efforts to mitigate future power costs after
- 2 the summer of 2000; and
- 3 • put in place a new contract that provides substantial benefits to
- 4 customers.

5
6 Q. How is your testimony organized?

7 A. Section I of my rebuttal testimony provides a chronology of Citizens' actual
8 efforts relative to managing its power supply and its contracts with Arizona
9 Public Service/Pinnacle West Capital Corporation (APS). Section II
10 addresses the assertions made by the Staff and RUCO witnesses and
11 demonstrates, point-by-point, why they do not comport with the facts in
12 this matter.

13
14 **I. CITIZENS' POWER SUPPLY CONTRACT MANAGEMENT**

15 Q. Please summarize Ms. Smith's statements relative to Citizens' management
16 of its power supply contract with APS.

17 A. Ms. Smith makes a number of assertions about what Citizens has done or
18 failed to do over the last several years in its management of its power
19 supply contract with APS. She suggests that "the Company's purchased
20 power costs were higher than necessary due to inadequate management of
21 the power supply contract and lack of actions to mitigate the price risks
22 inherent in the contract."

23
24 Q. Ms. Smith suggests that Citizens has not actively managed its power supply
25 contracts in recent years. Is that true?

26 A. Absolutely not. Citizens' customers have enjoyed some of the lowest
27 electric rates in Arizona for decades largely as a result of the economical
28 power supplies Citizens has been able to secure. Ms. Smith suggests that
29

1 at some point in the late 1990's Citizens failed to adequately manage its
2 power supply contract with APS. As a point of fact, Citizens has been
3 continuously engaged since 1998 in intensive power supply management
4 activities aimed exclusively at saving power costs for its customers.
5

6 Q. Did the 1995 power supply agreement with APS ("Old Contract") save
7 money for Citizens' customers?

8 A. Yes, it did. Citizens' original application in this matter provided an estimate
9 of savings under the Old Contract that have been realized since the time of
10 its inception in 1995 through the beginning of summer 2000. This estimate
11 is predicated on the observation that the Old Contract was substantially
12 based on purchasing power at APS' system incremental cost. The other
13 practical alternative at the time would have been an average system rate
14 contract with APS based on their embedded cost of power. Observing that
15 the baseload portion of Service Schedule A ("SSA") was established at a
16 level reflecting APS' average system costs, a calculation was performed that
17 compared actual billings to the charges that would have been billed if all
18 energy and demand were priced under SSA rates. This calculation indicates
19 that Citizens' customers saved approximately \$43 million in power supply
20 costs under the Old Contract prior to summer 2000 compared to an
21 average system cost agreement.
22

23 Q. Please summarize Citizens' power supply management activities.

24 A. I would categorize Citizens' key management activities into four efforts:
25 Stranded Cost Assessment and Mitigation; Re-negotiation of Schedule A;
26 the 1999/2000 Contract Efforts; and Post-Summer 2000 Activities.
27
28
29

1 Q. What was accomplished in the Stranded Cost Assessment and Mitigation
2 effort?

3 A. In its Stranded Cost Assessment and Mitigation efforts, Citizens modeled all
4 load and generation within the entire interconnected Western Systems
5 Coordinating Council ("WSCC") with the objective of forecasting market
6 prices for power delivered into Citizens' Arizona service areas and the
7 resulting stranded costs associated with the APS contract as well as
8 Citizens' planned construction of a combustion turbine facility in Mohave
9 County ("Mohave CT"). That effort is described in detail in a filing with the
10 ACC submitted in August 1998. A key outcome of that assessment was the
11 cancellation of the Mohave CT.

12
13 Q. Did the forecast of market price you reference include the span of time
14 relevant to this proceeding?

15 A. Yes, it did.

16
17 Q. Did Citizens' forecast predict the price spikes experienced in the summer of
18 2000 and beyond?

19 A. No, it did not. The forecast predicted the annual average market price for
20 power delivered into Citizens' service areas to be in the range of 2.3 - 2.5
21 cents per kWh in 2000 and 2001, a price far below what actually occurred.

22
23 Q. Did Ms. Smith's firm review the market price forecast?

24 A. I presume it did. Testimony on Citizens' stranded cost proposals was
25 submitted by Mr. Richard LaCapra, a principal of Ms. Smith's firm.

26
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28
29

1 Q. Did Mr. LaCapra's testimony question the accuracy of Citizens' forecast of
2 market prices and thus stranded costs?

3 A. No, it did not. Mr. LaCapra's testimony addressed stranded costs and the
4 success of Citizens' efforts to reduce them, but does not question the
5 accuracy of Citizens' market price forecast.
6

7 Q. Please address the second Citizens' effort you cite, the Re-negotiation of
8 Schedule A.

9 A. The re-negotiation of Service Schedule A ("SSA") of Citizens' Old Contract
10 with APS was initiated by Citizens in early 1998. A provision of the SSA
11 allowed either party to petition the FERC after May 31, 1998, to seek
12 changes in rates, with the caveat that, if Citizens were to make such a
13 filing, APS would not take a position that charges under SSA should be any
14 higher than APS' system average costs. Using publicly available
15 information and data provided by APS, Citizens estimated APS' embedded
16 cost of generation, determined such costs to be lower than the existing
17 charges under the SSA, and approached APS about lowering the SSA rates.
18

19 Q. Did APS readily agree to reduce the SSA rates.

20 A. No. A ten-month process ensued involving extensive negotiations. Only
21 after Citizens announced its intent to make a filing at the FERC did APS
22 finally agree to lower rates under SSA to a level very close to Citizens'
23 embedded cost estimate. Moreover, Citizens negotiated rate refunds
24 retroactive for several months prior to the signing of the negotiated
25 agreement.
26
27
28
29

1 Q. Did Staff and RUCO recognize these efforts?

2 A. Yes, they did. In testimony filed with the ACC, both parties acknowledged
3 that Citizens' efforts resulted in significant benefits to customers.
4

5 Q. How long did the process of Re-negotiation of Schedule A require?

6 A. Citizens initiated this process in March of 1998. The final signed agreement
7 lowering the rates was dated July 1999.
8

9 Q. Was this the only APS contract-related effort underway during that period?

10 A. No. In May of 1999, Citizens received notice from APS of a billing revision
11 for 11 months of 1998 that indicated Citizens owed APS approximately \$4.3
12 million.
13

14 Q. Did Citizens pay these charges?

15 A. Yes, it did. But, it paid them under protest pursuant to the billing
16 provisions of the Old Contract.
17

18 Q. What steps did Citizens then take?

19 A. The receipt of the May 1999 billing revision initiated what I have referred to
20 above as the 1999/2000 Contract Efforts. These efforts began on the heels
21 of the resolution of matters in the Schedule A re-negotiation and continued
22 through May 2000. Citizens requested and received large amounts of data
23 from APS, which Citizens analyzed. Citizens engaged APS in numerous
24 negotiation sessions. Citizens also retained legal counsel to assist it with
25 the APS contract-interpretation matters.
26
27
28
29

1 Q. What were the key areas of discussion in the 1999/2000 Contract Efforts?

2 A. Initially, the matters under discussion centered around the definition of
3 APS' system incremental costs ("SIC") and APS' ability under the contract
4 to charge Citizens for other than "economic purchases." An additional
5 theme, not well addressed in the intervenors' testimony, was also involved
6 in the contract discussions.

7
8 Q. Please elaborate on this additional theme.

9 A. After the initial discussions in the summer of 1999, when it became clear
10 that the parties held differing positions on the interpretation of the SIC
11 language in the Old Contract, APS in early September 1999, introduced the
12 concept of modifying the contract to remove the SIC concept entirely. APS'
13 interest in doing so stemmed from their pending Market-Based Rates Tariff
14 filing at the FERC in which APS would have to demonstrate that existing
15 wholesale customers would be held harmless by the transition from cost-
16 based to market-based pricing and the concomitant transfer of generation
17 assets into non-regulated subsidiary operations. APS' proposal was to
18 replace all Service Schedules with an indexed product using the Dow Jones
19 Palo Verde Trading Index and the California SP-15 hourly price shape.
20 While Citizens did not accept this proposal, the offer to use it led to a
21 broadening of the scope of the discussions from simply a billing dispute to
22 considering a complete restructuring of the contract.

23
24 Q. Please continue to describe the process and outcome of the 1999/2000
25 Contract Efforts.

26 A. During late 1999 and early 2000, the parties continued to seek resolution
27 of matters through meetings and correspondence. Citizens pursued three
28 negotiation objectives: 1) get relief from past improper billings under the
29

1 SIC; 2) either gain agreement from APS to properly bill under the SIC going
2 forward or change the contract to achieve an equally economical power
3 supply; and 3) change the contract to mitigate potential stranded costs
4 under competition. The intensity of the negotiations increased during the
5 second quarter of 2000 as the planned date for APS' FERC filing
6 approached.

7
8 Q. How were the 1999/2000 Contract Efforts resolved?

9 A. In early May 2000, Citizens made it clear to APS that it would protest at the
10 FERC in APS' Market-Based Rates matter if an acceptable arrangement
11 could not be reached. This position provided motivation to APS in the
12 meetings that followed - meetings that ultimately led to execution of the
13 May 18, 2000, Memorandum of Understanding ("MOU") entitled "Terms of a
14 Potential Restructuring of the Existing Power Supply Agreement Between
15 Citizens Utilities and APS." Ms. Smith included a copy of the MOU in the
16 Exhibits to her testimony. Through that document Citizens believed it had
17 achieved its negotiation objectives. First, the MOU provided for a refund of
18 \$1.5 million to settle past billing disputes. Second, it provided for
19 termination of all the Service Schedules, except the baseload block of
20 Service Schedule A, and their replacement with a single block of power
21 priced in a manner Citizens believed would benefit customers. In
22 particular, Citizens believed this change eliminated its exposure to the SIC
23 interpretation issues. Finally, the MOU allowed for the reduction of the
24 take-or-pay obligation of the baseload block of Service Schedule A
25 consistent with the loss of load to competition. This last provision all but
26 eliminated the generation-related costs that could be stranded by electric
27 competition.

1 Q. Why was an MOU used instead of a revised agreement?

2 A. The MOU was used as a prelude to a revised agreement to establish the
3 principles upon which the agreement would be based. The MOU was a first
4 step to a new, definitive agreement.
5

6 Q. What occurred after the signing of the MOU?

7 A. The parties began drafting the formal, detailed agreement that would
8 implement the contract modifications described in the MOU. Citizens also
9 received, in late June, its first extraordinarily high bill from APS for May
10 2000 service. Whereas normal May billing would have fallen in the area of
11 \$4 million and reflected unit costs of approximately 4 cents per kWh, the
12 May 2000 bill exceeded \$7.4 million, with a unit cost of over 6.4 cents per
13 kWh.
14

15 Q. Did APS provide you advance warning of high power costs?

16 A. The only advance warning that I recall receiving from APS was a phone call
17 shortly before the May 2000 bill was issued informing me that power costs
18 would be unexpectedly high.
19

20 Q. What did Citizens do following receipt of the May 2000 bill?

21 A. Citizens immediately launched a bill audit procedure that has been
22 described in the Company's applications and in testimony. Any payments
23 to APS thereafter were made under protest, as defined by the Old Contract.
24 Citizens also re-doubled its efforts to finalize the new contract with APS,
25 which in Citizens' view, would protect Citizens' customers from the kind of
26 charges the Company had experienced in the May 2000 bill.
27
28
29

1 Q. Why did Citizens believe the new contract would protect it against high
2 power charges?

3 A. Citizens believed it was protected because of provisions in the new contract
4 concerning pricing and the established precedent for billing under Schedule
5 A.

6
7 Q. Please explain what you mean by the "established precedent for billing
8 under Schedule A."

9 A. The new contract under development would include two key components,
10 the 100 MW baseload block of Schedule A and the "new" block, which would
11 be priced in one of two ways, based on Citizens' election. In Citizens' view,
12 pricing under the baseload block of Schedule A was based on the embedded
13 cost of APS' owned generation. The calculation of Schedule A rates in the
14 original FERC application, under which the Old Contract was approved, was
15 done in this manner, and moreover, APS had acquiesced to lower the
16 charges under Schedule A after Citizens demonstrated in 1998 that APS'
17 embedded costs were in fact lower than in the original application. Also, I
18 need to stress that no bill under the contract prior to the summer of 2000
19 (including the original May 2000 bill) had ever even shown the calculation
20 of the "Minimum Charges" for Schedule A (which would have included the
21 at-issue SIC calculations), let alone used such a calculation as the basis for
22 billing. There was simply no indication or reason to believe at that time
23 that APS would take the unprecedented step of basing Schedule A charges
24 on Minimum Charge billing.

25
26 Q. Please explain pricing under the "new" block.

27 A. The "new" block of power under the contract was to reprice SSA Off-Peak,
28 Service Schedule B ("SSB") and Service Schedule C ("SSC") energy at a
29

1 single price. That price was to be set based on one of two pricing options
2 elected by Citizens:

3 1. **Monthly Pricing Option (MPO):** Under this option, energy for a
4 particular month would be priced at the level of actual aggregate
5 1999 unit costs for power under SSA Off-Peak, SSB, and SSC
6 indexed to the change in APS' 1999 cost of natural gas.

7 2. **Variable Time Period Pricing Option (VTO):** Under this option,
8 Citizens would specify a forward time period and APS would
9 provide a fixed price for energy for the period. This fixed price
10 would be the actual cost of power in 1999 for the relevant service
11 schedules indexed to the ratio of: (i) the forward price of natural
12 gas to; (ii) APS' cost of gas for the same period in 1999.

13 The VTO option could have provided Citizens the ability to hedge its power
14 purchases—to buy forward based on the weighted average of the monthly
15 futures contract prices of natural gas. In negotiations, APS indicated that
16 whenever Citizens elected this option APS would simply go out and secure
17 fixed prices for gas and thereby hedge the cost of providing the power to
18 Citizens.

19
20 Q. How did these pricing options protect Citizens against APS' invoking its
21 interpretation of SIC pricing?

22 A. These pricing options would have protected Citizens in two ways. First, the
23 new pricing replaced the nominal pricing formulas under SSA Off-Peak and
24 SSB that included SIC. Second, the VTO option would have provided, in
25 Citizens view, an unambiguous way to establish with certainty what its
26 prices would be for a forward period, that is, a way to hedge power
27 purchases for its customers. In this way, APS purchased power costs which
28 impacted their SIC calculation would no longer be relevant. Citizens' costs
29

1 would be tied to natural gas futures and not subject to the vagaries of
2 purchased power transactions.

3
4 Q. Why did Citizens and APS not execute the new pricing arrangements?

5 A. June and early July 2000 were devoted to hammering out details of the
6 new pricing arrangements. After receipt of the APS May 2000 bill in late
7 June, attention was diverted to initiating the audit procedures. In mid-
8 August a meeting was held with APS to, in part, renew the efforts to finalize
9 the new agreements. At that meeting explicit confirmation was sought and
10 received by Citizens from APS that, when Citizens elected to fix pricing
11 under the VTO, the price would in fact be fixed and not subject to the floor
12 pricing provisions that invoked the SIC charges. Later that month in a
13 follow-up meeting, APS completely reversed itself on its earlier
14 commitment. With that reversal, the value of the new pricing arrangement
15 was rendered virtually worthless and no further negotiations on the subject
16 were pursued. Citizens had proceeded with these negotiations in good
17 faith, but ultimately APS' actions made it impossible for any further useful
18 discussions.

19
20 Q. Do you believe APS anticipated the extraordinary market power costs it
21 incurred in the summer of 2000?

22 A. No, not to the extent of the price increases that actually occurred.

23
24 Q. On what do you base that belief?

25 A. I base that belief on two observations. First, had APS anticipated the
26 magnitude of what in fact occurred, it would have given Citizens more
27 advance notice given the context of the ongoing contract negotiations. In
28 the early part of the summer 2000, both parties were motivated to
29

1 restructure the existing contract and were working intently to do so.
2 Reasonably, APS would have forewarned Citizens of the pending price
3 increases to avoid having high bills disrupt the negotiation process.
4 Second, and most importantly, in late May/early June 2000 APS was
5 negotiating a new pricing arrangement with Citizens that would have
6 undermined their ability to recover the extraordinary market price levels
7 from Citizens. The pricing under negotiation was tied to the cost of natural
8 gas. Clearly, APS was viewing the recent increases in natural gas costs as
9 the driving force behind the rise in market prices and was attempting to
10 craft a new pricing arrangement with Citizens that would shield APS from
11 such increases. Had APS recognized the extent of electric market price
12 increases that were about to occur, APS would never have limited the
13 contract pricing only to the change in natural gas prices. As has been
14 described in Citizens' original application, the unprecedented price increases
15 in the electric market were driven well-beyond the levels that the input fuel
16 cost would suggest essentially as a result of an imbalance between supply
17 and demand. By limiting its charges to Citizens (knowing that it was
18 resource-short in the summer peak periods) to no more than the change in
19 natural gas prices, APS would have placed itself in a position of potentially
20 taking a loss on sales to Citizens. Had APS anticipated the pending
21 increase in electric prices it would not have made these offers to Citizens.
22

23 Q. Do you believe APS made these offers knowing that it simply could rely on
24 floor pricing provisions to "bail it out" under these circumstances?

25 A. No. The parties entered negotiations with the clear intent that SIC
26 language was to be removed from the pricing arrangements. APS agreed
27
28
29

1 to pricing options that fixed prices based exclusively on natural gas futures
2 prices. APS did not anticipate at the early stages of negotiations that any
3 further protections were needed in the new contract under discussion.
4

5 Q. Did APS' view on this issue eventually change?

6 A. Yes, its views did change sometime in mid- to late-August 2000.
7

8 Q. Why do you conclude that APS' views on SIC floor pricing changed in
9 August 2000?

10 A. Two events that I have described occurred in that time frame. First, APS
11 reversed its earlier commitments in contract negotiations concerning SIC
12 floor pricing, as I have described above. Second, in late August 2000, APS
13 submitted a revision to its May and June 2000 bills, revisions that for the
14 first time in the contract's history invoked floor pricing for the Schedule A
15 baseload block.
16

17 Q. Why do you believe APS changed its views in this regard?

18 A. APS changed its views to protect its financial interests. It had made
19 commitments to Citizens to tie contract pricing to the cost of natural gas
20 and realized only after-the-fact (after the extraordinary cost increases
21 driven by factors other than solely the increase in gas costs) that it could
22 not honor those commitments without potentially losing money under the
23 new contract. Further, not having anticipated the magnitude of the
24 unprecedented market price increases experienced in the early part of
25 summer 2000, APS decided to take an aggressive stance on the
26 interpretation of SSA to avoid losing money on current sales to Citizens. It
27 did so by revising both May and June 2000 bills invoking for the first time
28 the Minimum Charge under the SIC floor pricing provisions of SSA.
29

1 Q. Was Citizens concerned about this behavior by APS?

2 A. Yes, Citizens was extremely troubled. Following these events, Citizens
3 initiated what I referred to earlier as the Post-Summer 2000 Activities.

4
5 Q. How did Citizens proceed from this point?

6 A. This period of activity involved: completion of Phase I and Phase II of the
7 process of auditing APS' summer 2000 bills; analysis of possible legal
8 actions against APS; preparations to mitigate cost impacts in the summer of
9 2001; and finally, the signing of the new supply contract with APS effective
10 June 1, 2001. Many of these activities are addressed in my direct
11 testimony, but I will summarize them here for convenience.

12
13 Q. What were the findings of Phase I and II of the audit process?

14 A. As indicated in Citizens' September 2001 amended application, placing to
15 one side the parties' differences in contract interpretation, the Phase I/II
16 audit process did not identify any significant practices that would have
17 resulted in excessive charges to Citizens.

18
19 Q. What about Phase III of the audit process?

20 A. Phase III of the audit process was not completed. Citizens submitted a
21 comprehensive data request to APS, but APS refused to respond to the data
22 request on grounds that it was not required to do so under the Old
23 Contract. Consequently, it was not possible to proceed with the Phase III
24 analysis.

25
26 Q. Dr. Rosen has suggested that Citizens could have compelled APS to respond
27 to the Phase III data requests if Citizens had made a filing at the FERC on
28 this matter. Why did Citizens not do so?

29

1 A. Filing a complaint with the FERC on the contract interpretation matter was
2 under consideration at the time as part of Citizens' legal analysis. I will
3 summarize that analysis here, but the precise details of Citizens' legal
4 analysis are presented by Mr. Paul Flynn in his rebuttal testimony on behalf
5 of Citizens.

6
7 Q. Please summarize Citizens' legal analysis.

8 A. In the fourth quarter of 2000, Citizens retained the services of Wright &
9 Talisman, P.C. to explore options for pursuing the APS contract matters in
10 the courts or before the FERC. Based on early review of information and
11 strategy development for possible legal actions, it appeared that Citizens
12 had a better-than-even chance to prevail. Consequently, Citizens continued
13 to pursue its legal options. Unfortunately, as more fully described by Mr.
14 Flynn in his rebuttal testimony, more in-depth research ultimately revealed
15 that the chances of success at the FERC or the courts was highly uncertain.
16 It was also clear that pursuit of these options would likely involve years of
17 litigation before matters were resolved one way or the other.

18
19 Q. What did Citizens do as a result?

20 A. Faced with the uncertain outcomes and the cost for pursuing legal options
21 measured not only in legal costs, but more importantly, by the prospect of
22 continued high power costs impacting both the customers and the Company
23 during years of litigation, Citizens determined that the only reasonable
24 course of action was to seek a new power supply contract with APS.

1 Q. Did the Post-Summer 2000 Activities also include actions by Citizens to
2 mitigate potential adverse cost impacts in the summer of 2001?

3 A. Yes, they did. Chief among these activities were enhancements to the
4 Valencia Power Plant to enable it to be used to offset a portion of high
5 power charges from APS and the initiation of a new demand-side
6 management effort, a Voluntary Curtailment Program ("VCP").
7

8 Q. Please describe the enhancements to the Valencia Power Plant.

9 A. The Valencia Power Plant has served principally as an emergency backup to
10 the single radial transmission line importing power into the Santa Cruz
11 Electric Division and also to provide capacity credits under the Old Contract
12 with APS. Following the events of summer 2000, Citizens explored what
13 improvements and changes would need to be made to the Valencia Plant to
14 allow it to be used to generate power to serve local load to avoid
15 purchasing high cost power from APS. During the Fall, Winter, and early
16 Spring of 2000-2001, the AED implemented a number of changes and
17 enhancements to the plant to prepare for potential operation in a load-
18 serving mode. These included: running performance tests on the machine
19 governor and control system; replacing breakers at the Valencia
20 Substation; undertaking a stability study investigating operation of the
21 generators while serving load; updating of the turbine control system;
22 installing a continuous emissions monitoring system and seeking an
23 amendment to its Air Quality Permit; overhauling key components of the
24 machines; and making arrangements for fuel supply. In addition, Citizens
25 made arrangements with APS for receiving regular updates on the expected
26 cost of power for serving Citizens' load. With these preparations in place,
27
28
29

1 Citizens began in May 2001 to operate the Valencia turbines to avoid high
2 power charges from APS. In that month alone, Citizens estimates that it
3 achieved net savings of approximately \$900,000 in power supply costs.
4

5 Q. Why did Citizens not continue operation of the Valencia turbines in this
6 way?

7 A. Citizens ceased operation of the Valencia turbines to carry load, because
8 the implementation of the new power supply contract in July 2001
9 (retroactive to June 1, 2001) made it unnecessary, and in fact
10 uneconomical, for Citizens to run the Valencia facilities for carrying load. As
11 described in Citizens' Amended Application in this proceeding, economic
12 dispatch of the Valencia turbines falls under APS' control, with Citizens
13 retaining the right to operate the turbines for local area reliability. I would
14 also note that the Commission Staff expressed concern with Citizens'
15 operation of the Valencia turbines in a load-carrying mode in July 2001, due
16 to the potential for such operation to impact local reliability. A subsequent
17 meeting with Staff on this matter resulted in a change in operation policy
18 for the Valencia turbines to minimize the risk of reliability issues when the
19 turbines were operated by APS for economic reasons.
20

21 Q. Please describe Citizens' efforts relative to the Voluntary Curtailment
22 Program.

23 A. Given the expectation of a repeat in the summer of 2001 of very high APS
24 charges, Citizens also developed a new load-management initiative called
25 the Voluntary Curtailment Program, which would allow qualifying customers
26 the opportunity to decide whether to curtail load during times of high
27 energy costs in return for bill credits based on Citizens' avoided costs.
28 Under the VCP, customers could curtail load by shutting down, rescheduling
29

1 operations, using backup generating equipment or conserving energy
2 usage. In May 2001, Citizens filed for and received Commission approval
3 for a voluntary service curtailment tariff rider for its largest commercial
4 power customers. Following approval, final implementation details for the
5 VCP were undertaken, including: customer enlistment; baseline load
6 metering; arrangements for day-ahead hourly pricing information from
7 APS; and web-site posting of curtailment prices. Ultimately the new APS
8 power supply contract, implemented effective June 1, 2001, with its low,
9 fixed pricing, made it unnecessary for the AED to move forward with VCP
10 implementation.

11
12 **II. REBUTTAL OF ASSERTIONS MADE BY STAFF AND RUCO WITNESSES**

13 Q. What are the assertions made by Staff consultant Lee Smith that you will
14 address in your rebuttal testimony?

15 A. I will address the assertions made by Ms. Smith that Citizens:

- 16 • did not take reasonable steps to resolve ambiguities in the Old
17 Contract;
- 18 • did not pursue an intensive negotiation strategy with APS;
- 19 • should have asked APS to hedge power purchases on its behalf; and
- 20 • should have run the Valencia generation to avoid APS charges.

21
22 Q. What matters will you address relative to Dr. Rosen's testimony?

23 A. I will rebut Dr. Rosen's arguments concerning Citizens' new contract for
24 power supply with Pinnacle West Capital Corporation.

1 Q. Please summarize Ms. Smith's statements concerning Citizens' failure to
2 take adequate steps to mitigate impacts of the Old Contract.

3 A. Ms. Smith begins her testimony with a sweeping statement that "the
4 Company's purchased power costs were higher than necessary due to
5 inadequate management of the power supply contract and lack of actions to
6 mitigate the price risks inherent in the contract."
7

8 Q. Do these sweeping statements have merit?

9 A. Not at all. In the preceding section of my rebuttal testimony I have
10 reviewed the facts surrounding Citizens' extensive efforts in the
11 management of its power supply contracts. I have also shown how Citizens
12 took focused actions to restructure its contract to avoid being subject to
13 APS' interpretation of the pricing mechanisms. Ms. Smith's assertion is
14 simply untrue.
15

16 Q. On page 37 of her testimony, Ms. Smith characterizes Citizens attempt to
17 renegotiate its contract with APS as "very modest." Do you agree with this
18 characterization?

19 A. Absolutely not, her characterization is completely inaccurate. To dismiss
20 Citizens' negotiation efforts in the spring of 2000 as "some exchanges of
21 letters and discussions" and "apparently further discussions between the
22 parties with regard to the proposed contract change" is simply outrageous;
23 it is a total mischaracterization of the intense negotiations between the
24 companies, involving the most senior management for both parties. I was
25 personally involved in every step of the process and know from direct
26 experience that Ms. Smith's assertions that Citizens engaged APS in "very
27 modest" negotiations are totally without basis.
28
29

1 Q. Were you personally involved in the preparation of the MOU discussed in
2 Ms. Smith's testimony?

3 A. Yes, I was.
4

5 Q. What was the purpose of the document?

6 A. The MOU set forth the basic understanding of the parties for restructuring
7 power supply arrangements with the understanding that the parties would
8 move forward with the preparation of a new detailed agreement that would
9 incorporate the MOU understandings.
10

11 Q. Was it the intent of the parties that the MOU eliminated the minimum bill
12 provisions?

13 A. Yes, it was. The operative word regarding SSA Off-Peak, SSB and SSC was
14 that the MOU would "terminate" those provisions of the agreement. The
15 MOU did not include explicit termination of all of the SSA because APS was
16 not willing to relinquish the certainty of the cash flows from the demand
17 charges under the baseload portion of SSA. However, by terminating the
18 other service schedules the so-called floor provisions, which were described
19 in an exhibit to each schedule, would also be terminated. Clearly, the
20 parties agreed, in principle at the time the MOU was signed, that the SIC
21 floor provisions would no longer apply, nor would any other aspect of SIC
22 pricing in the schedules.
23

24 Q. Ms. Smith has characterized the MOU as an "imprecise framework for a
25 contract that might or might not have been adopted at some point in the
26 future." Is that an accurate characterization?

27 A. No. The use of a Memorandum of Understanding or Letter of Intent, as an
28 initial step of contract development to document the principles to which the
29

1 parties have agreed, is a common practice in the utility business, and, I
2 expect, other industries do as well. These documents are not meant to
3 capture every detail of a potential agreement, but rather to provide a
4 conceptual basis on which a final agreement can be built. To characterize
5 the MOU as an "imprecise framework" is simply an attempt by Ms. Smith to
6 obfuscate the truth of the matter; the parties had worked long and hard to
7 reach this point and made a focused effort to memorialize their
8 agreements. To suggest, as Ms. Smith does, that the contract "might or
9 might not have been adopted" is a baseless assertion. At the time it was
10 signed, both parties were keenly interested in achieving the objectives
11 outlined in the MOU and, immediately after signing, the parties began
12 development of a definitive contract to replace the Old Contract. By
13 executing the MOU, Citizens had secured reasonable assurance from APS
14 that it would follow through on its word to pursue a wholesale restructuring
15 of the contract. It is Citizens' view that only after the unanticipated
16 skyrocketing of market prices when APS realized it would lose the
17 convenient advantages it viewed were embodied in the SIC floor provisions,
18 did APS decide to reverse its position on structuring a pricing arrangement
19 that would not be impacted by these provisions. There was no way for
20 Citizens to foresee that APS would take these actions.

21
22 Q. On page 40 of her testimony, Ms. Smith characterizes APS' agreement to
23 eliminate the floor pricing as a "verbal commitment." Do you agree with
24 that characterization?

25 A. No. As I have described, it was a central goal of both APS and Citizens in
26 the negotiations leading up to the MOU to eliminate the complications
27 posed by the SIC language in the Old Contract. Ms. Smith's
28 characterization was derived from a memorandum to file that I prepared in
29

1 August 2000. In that memorandum, I describe the verbal assurances I
2 sought and received from APS about the contract restructuring that was
3 underway, and later the verbal reversal on those commitments. I asked for
4 clarification from APS that fixed pricing under the VTO option, if elected,
5 would not be subject to SIC floor pricing provisions because that feature of
6 our new agreement was so critical to its value to Citizens. This was an
7 important clarification at the time, because APS was then billing Citizens
8 under the floor provisions (including SSA baseload for the first time) for its
9 current purchases. In Citizens' view, the MOU had established this point
10 with its termination of the service schedules. However, given APS' novel
11 and aggressive interpretation of the then-existing contract, I believed it was
12 important to seek clarification on critical contract re-structuring matters,
13 even though such matters were abundantly clear to Citizens.
14

15 Q. On page 41 of her testimony, Ms. Smith states, relative to the MOU, that
16 Citizens "should have taken the proper steps to enforce its understanding of
17 what had transpired." What did Citizens do in this regard?

18 A. Once this reversal occurred, the parties were at an impasse. APS was
19 essentially sending the message that, if Citizens wanted to "enforce its
20 understanding," the only way to do so would be through legal channels. My
21 purpose for writing the memorandum to file dated August 29, 2000,
22 concerning the APS reversal was to document this matter for potential use
23 in future regulatory or legal proceedings. Subsequent to this event,
24 Citizens intensified its legal investigation and this matter was included in
25 the analysis of the overall prospects of pursuing legal action against APS.
26 Ultimately, Citizens concluded that the outcome of litigation was highly
27 uncertain and therefore not worth the risks of pursuit. Mr. Flynn addresses
28 Citizens' legal analysis in his testimony.
29

1 Q. On page 2 of her testimony, Ms. Smith states that Citizens did not
2 recognize the lack of clarity in the floor pricing provisions of the Old
3 Contract. Is that true?

4 A. It stretches credulity to suggest that Citizens did not recognize the differing
5 interpretations in the contract language, when nearly one-year of its
6 negotiation efforts were focused on that topic. Even though, prior to
7 summer 2000, the floor pricing provisions had not caused any material
8 impact on costs, Citizens fully recognized the import of the disagreement in
9 interpretation of SIC language. That is why Citizens engaged APS in
10 focused discussions when the May 1999 APS billing revision crystallized the
11 difference in interpretation between the parties.

12
13 Q. Is it true, as Ms. Smith states, that Citizens was aware of the ambiguities in
14 the Old Contract in 1999.

15 A. Yes, it is. However, it is not true, as she also states, that Citizens did not
16 take reasonable steps to mitigate the impact of this problem. The MOU of
17 May 18, 2000, which I have described, was the result of many months of
18 negotiations by Citizens. In Citizens' view, that document, among other
19 benefits, resolved all ambiguities in the Old Contract.

20
21 Q. If that is true, why did Citizens experience the high costs during the
22 summer 2000?

23 A. Citizens experienced the high costs as a result of APS' reversal of its prior
24 commitments in negotiations and its aggressive interpretation of SSA,
25 which it developed mid-summer 2000. Citizens entered negotiations in
26 good faith and could not have reasonably anticipated that APS would not
27 honor its commitments to change the contract or that it would develop a
28 completely new approach to billing SSA.

1 Q. Is it true that Citizens could have anticipated the price increases that
2 occurred in summer 2000?

3 A. No. No one, to my knowledge, anticipated the magnitude of the market
4 price spikes that actually occurred. Dr. Avera addresses this matter in his
5 rebuttal testimony on Citizens' behalf.
6

7 Q. Why is the magnitude of price increases important?

8 A. The market price spikes experienced in summer 2000 were extraordinary
9 and completely unprecedented. Ms. Smith acknowledges this fact when she
10 states in her testimony at page 18: "...Citizens could not have known for
11 certain that its power costs would be significantly higher than normal, which
12 proved to be the case." This is an important observation on her part. It is
13 only because of the unprecedented magnitude of the increase in power
14 costs that we are here today.
15

16 Q. What is the timeframe during which Ms. Smith asserts Citizens should have
17 known that prices in summer 2000 would increase?

18 A. Ms. Smith suggests that in late 1999 and early 2000 Citizens should have
19 known that market prices would increase for summer 2000.
20

21 Q. Were other relevant regulatory proceedings underway during that time
22 period?

23 A. Yes. The Commission Staff was working with several parties including APS,
24 Tucson Electric Power ("TEP"), Arizona Electric Power Cooperative
25 ("AEPCO") and Citizens on resolving stranded cost issues associated with
26 electric competition open access.
27
28
29

1 Q. What about these proceedings makes them relevant to this proceeding?

2 A. The establishment of the competitive transition charge ("CTC") for these
3 utilities required consideration of a reasonable projection of the market
4 price for power during the period rates would be in effect. This was so
5 because the CTC was defined as the difference between the utilities' cost of
6 generation and the expected market price. Since the current matter
7 concerns expectations of market price during 2000, which is within the
8 period under consideration in the stranded cost proceedings, the prevailing
9 view of Staff on this matter is relevant.

10

11 Q. Who was advising Staff on this matter at the time?

12 A. Ms. Smith and her firm were advising Staff in all of the stranded cost
13 proceedings underway at the time.

14

15 Q. What projections on the level of market price were set forth during this
16 time period by Staff?

17 A. I have not been able to gather all such projections, but I have reviewed
18 evidence of two market price projections supported by Staff. In the AEPCO
19 proceedings, Staff recommended that the expected market price for power
20 for the summer of 2000 be established at 3 cents per kWh. In testimony
21 submitted February 16, 2000, Ms. Smith states at page 3:

22

23 I recommend that AEPCO be allowed a CTC that will be calculated
24 based on the formula proposed by the Cooperative, **with the**
25 **exception that the initial year market price should be \$.03 per**
26 **kilowatt hour** [Emphasis added].

26

27 This recommendation also appears as a Finding of Fact in Commission
28 Decision No. 62758, issued July 27, 2000. As further evidence of Ms.

28

29

1 Smith's expectation of low market prices for 2000, the stranded cost
2 settlement agreement with APS, approved in Decision No. 61973, October
3 6, 1999, contains an implied market rate for service to APS' residential
4 customers of approximately 3.5 cents per kWh.
5

6 Q. Did Staff rely on the expert opinion of Ms. Smith and her firm in developing
7 these market price values?

8 A. Yes. As consultant to Staff in these matters, I expect that Ms. Smith had
9 direct involvement in developing these anticipated market prices.
10

11 Q. Are Ms. Smith's assertions about what Citizens should have known about
12 market prices in late 1999 and early 2000 consistent with the market price
13 projections she and her firm were developing in the same general time
14 period?

15 A. No, not at all. It is abundantly apparent from these decisions that Ms.
16 Smith and her firm did not anticipate the market prices that actually
17 occurred in 2000 when she was advising Staff on these matters. The
18 prevailing view at the time was stranded costs were going to exist, which
19 translates to the anticipation that market prices were going to be lower
20 than utility generation costs. Yet, Ms. Smith goes on for several pages in
21 her testimony arguing why she believes Citizens, during this same time
22 period, should have known "that there was a reasonable possibility that
23 power costs [for summer 2000] would be much higher than historic costs"
24 (page 19, lines 2-3).
25
26
27
28
29

1 Q. What do you conclude from this?

2 A. Ms. Smith is using hindsight alone to make an unreasonable assertion
3 about what was reasonably foreseeable by Citizens. Mr. Dabelstein
4 discusses this matter in more detail in his testimony.
5

6 Q. On page 29 of her testimony Ms. Smith states her opinion that even if
7 Citizens could not have known how high prices would rise, it should have
8 been concerned. Do you agree with that assessment?

9 A. Yes, because Citizens was concerned. Citizens understood that even under
10 the nominal pricing provisions of SSA Off-Peak and SSB, Citizens was
11 subject to market price impacts under the Old Contract. It further
12 understood very well that the companies disagreed on how pricing was to
13 be calculated. It is because of this concern that Citizens negotiated long
14 and hard to attain an agreement with APS to terminate the existing service
15 schedules and replace them with pricing arrangements that did not rely on
16 SIC calculations.
17

18 Q. Ms. Smith suggests in several places of her testimony that Citizens should
19 have in some manner hedged against price volatility. Was Citizens
20 pursuing hedging strategies prior to summer 2000?

21 A. Yes, it was. The new pricing arrangement contemplated in the May 18,
22 2000, MOU included the VTO pricing option I described earlier, which would
23 have allowed Citizens to fix prices for power from APS in advance based on
24 futures contract prices for natural gas. Had this been implemented, it
25 would have given Citizens the ability to do precisely what Ms. Smith
26 suggested. Citizens viewed the VTO as an unambiguous way to avoid the
27 potential for exposure to high SIC pricing, as it was envisioned by the
28 parties during negotiations that Citizens' purchase transactions under the
29

1 VTO would be tied to specific forward purchases of natural gas volumes by
2 APS to back up sales to Citizens (or the use of financial derivatives). In this
3 way, APS' incremental cost to serve Citizens' load is defined in advance and
4 tied to sales to Citizens.
5

6 Q. Again, Mr. Breen, why was this new pricing arrangement not implemented?

7 A. In the middle of negotiations (mid-August 2000), APS reversed its earlier
8 commitment to exempt VTO purchases from SIC floor pricing, which
9 rendered the pricing option of no value to Citizens. APS was taking the
10 position that - notwithstanding its earlier agreement to the contrary - it was
11 unwilling to directly assign forward purchases to Citizens sales. This
12 reversal terminated the possibility for any further productive negotiations
13 on this topic.
14

15 Q. If Citizens had successfully put the VTO pricing arrangement in place, would
16 it have implemented the option without first seeking Commission guidance
17 on the use of hedging instruments?

18 A. No. Citizens would not have proceeded with any significant hedging
19 activities, based on forward purchase or derivative transactions, without
20 first seeking clarification from the Commission on a number of issues. In
21 its original application in this proceeding, Citizens set forth the key
22 questions it believed needed to be addressed. Mr. Dabelstein further
23 addresses this issue in his rebuttal testimony.
24

25 Q. Ms. Smith suggests that, to the extent it believed it necessary, Citizens
26 could and should have requested Commission guidance on hedging long
27 before its original application in September 2000. Do you agree with her
28 assertions?
29

1 A. No. Ms. Smith is simply enjoying perfect hindsight. I would agree with Ms.
2 Smith's assessment if it were reasonably possible to foresee the magnitude
3 of the price increases that ultimately occurred. But, Ms. Smith herself has
4 acknowledged that this was not possible. As I've discussed, she also
5 advised Staff and this Commission in late 1999 and early 2000 of market
6 price estimates well below Citizens' base costs of power. While the forward
7 purchases Ms. Smith recommends are a form of risk management, they
8 also involve risk – the risk of being wrong and of later being judged
9 imprudent as a result. Given the lack of any reasonable expectation of
10 significant price volatility and lack of Commission guidelines on hedging,
11 Citizens had no reason to take the steps that Ms. Smith suggests.

12
13 Q. What other actions does Ms. Smith suggest Citizens should have taken in
14 advance of the summer of 2000?

15 A. Ms. Smith suggests that sometime in late 1999 or early 2000 Citizens
16 should have made improvements to its Valencia generating facilities to
17 prepare them for operation on an economic-dispatch basis. She goes on to
18 suggest that such operation in the summer 2000 could have saved \$4 to \$5
19 million.

20
21 Q. Is this a reasonable expectation?

22 A. No. As I have discussed exhaustively, the prices experienced in summer
23 2000 were not reasonably foreseeable in late 1999 and early 2000 when
24 Citizens would have had to initiate the improvements addressed by Ms.
25 Smith. This is particularly the case considering the very low efficiency of
26 the units, and thus high output costs, which are in the range of \$.10 - \$.15
27 per kWh. This is almost double the highest month of forward prices which
28 Ms. Smith discusses at page 28 of her testimony.

1 Q. Directing your attention to Dr. Rosen's testimony, is it true, as he asserts
2 on page 6, that with the exception of the Phase I and Phase II
3 investigations, Citizens "did very little to further protect its ratepayers from
4 additional high bills that occurred after its initial application in this docket
5 was filed...?"

6 A. No, not at all. As I have described here, after the September 2000 filing of
7 its original application, Citizens undertook a number of focused efforts to
8 mitigate power costs including extensive legal analyses of potential
9 litigation against APS, further intensive negotiations with APS,
10 comprehensive improvements to the Valencia facilities to enable them to
11 operate on an economic-dispatch basis and implementation of a Voluntary
12 Curtailment Program. To suggest that the only significant activity during
13 this period was to "make overtures to APS in an attempt to negotiate a
14 deal..." is an outrageous misrepresentation of what occurred.

15
16 Q. Do you agree with Dr. Rosen's conclusion that there is no significant
17 economic value for ratepayers in resolving stranded cost issues.

18 A. No. Dr. Rosen characterizes stranded cost in his testimony as simply how
19 customers' bills "might be sub-divided into component parts." This is a
20 gross over-simplification. Dr. Rosen participated in Citizens' stranded cost
21 proceedings before the Commission, and should recall that a major issue in
22 opening Citizens' service territory to competition was the costs associated
23 with the essentially take-or-pay provisions of the SSA long-term baseload
24 capacity. The issue was a thorny one. When customers left Citizens'
25 generation, baseload generation costs could not be avoided and therefore
26 remaining ratepayers would be strapped with paying for the portion of
27 baseload generation no longer supported by the departing customers. To
28 correct for this situation, departing ratepayers would pay a stranded cost
29

1 charge. Ultimately, Citizens negotiated an arrangement with APS in which
2 the amount of baseload capacity it would have to purchase could be
3 lowered over time consistent with load lost to competition. However, as Dr.
4 Rosen should also recall, implementation of the recovery mechanism for
5 stranded costs involved a rather complex process for calculating the
6 difference between lost generation revenues and the costs actually avoided
7 as a result of customer departing Citizens' generation. Citizens' point, set
8 forth in its Amended Application, which remains valid despite Dr. Rosen
9 opining to the contrary, is that Citizens' new contract unambiguously
10 eliminates stranded costs because charges are 100% variable.

11
12 Q. Do you agree with Dr. Rosen's assessment that the administrative
13 simplicity of the new contract is of little value?

14 A. Absolutely not. This proceeding is clear evidence of how high the cost of
15 administering complex contracts can be for both the utility and its
16 customers. Citizens has expended several hundred thousand dollars in
17 legal and consulting fees, many person-months of staff time, and other
18 significant expenses in connection with the APS contract issues that are the
19 subject of Citizens' application. In addition to the direct expense, the
20 diversion of having to contend with contract disagreements necessarily
21 takes away from focus on other important aspects of business
22 administration. The simplicity of the new power supply contract should
23 avoid these issues in the future.

24
25 Q. On page 25 of his testimony, Dr. Rosen questions whether the FERC
26 regards Citizens new contract as "just and reasonable" under the Federal
27 Power Act. Should the Commission be concerned about this assertion?
28
29

1 A. No. The FERC has accepted the filing of Citizens' new contract and by
2 doing so has established that it is just and reasonable. Moreover, Dr.
3 Rosen's statements that the standard for FERC review is whether the
4 contract is cost-based are not correct. Wholesale power prices are no
5 longer regulated on a cost basis by the FERC.

6
7 Q. On page 21 of his testimony, Dr. Rosen discusses why the stability afforded
8 by Citizens' new contract "may not be worth much compared to having
9 lower average retail rates..." Do you agree with his assessment?

10 A. No. Dr. Rosen asks us to accept several questionable or incorrect
11 assumptions to back his statement. His argument about the price risk of
12 the new contract is based on the unsubstantiated speculation that the
13 historical average wholesale price of power under the Old Contract may
14 turn out to be the same price experienced over the next seven years. In
15 fact, neither Citizens nor Dr. Rosen can know what wholesale prices will be
16 over the next seven years. Clearly, the volatility experienced over the last
17 two years in electric prices has provided evidence of the significant extent
18 to which prices can increase. While, those increases may be moderated as
19 a result of the June 19, 2001, FERC price mitigation order applicable
20 throughout the West, it remains the case that prices will be subject to the
21 price and volatility of the underlying fuel costs and other factors.

22
23 Q. Dr. Rosen suggests that Citizens get a 7-year levelized price for power to
24 serve as the basis for comparison to the contract price. Why is such a
25 comparison not valid?

26 A. Such a comparison is not valid because: 1) Citizens was not free to accept
27 a market bid for power at the time it entered the new contract; and 2) to
28 make that same comparison today under a different set of market
29

1 conditions would be meaningless. Citizens negotiated what was the best
2 possible price under the circumstances at the time. However, under the
3 former power supply agreement, Citizens was bound to a long-term
4 contract with APS and was not in a position to dictate price or simply walk
5 away and accept a competitive price from another entity.
6

7 Q. On pages 26 and 27 of his testimony, Dr. Rosen discusses the timing of the
8 signing of the new contract. Please summarize that discussion.

9 A. Dr. Rosen observes that the FERC issued its western price mitigation Order
10 close to the time Citizens signed its new contract with APS. That Order
11 concluded, in part, that unjust and unreasonable rates for power were
12 charged during the 2000-2001 western power crisis. Dr. Rosen concludes
13 that Citizens was likely influenced by the prior-year unjust and
14 unreasonable power costs when it agreed to sign the new contract and
15 further, that the price level in the new contract was also affected by the
16 prior-year costs.
17

18 Q. Is Dr. Rosen correct in this assessment?

19 A. No. While it is true that Citizens was motivated in part to pursue a new
20 contract to avoid the possibility of incurring high market prices in the
21 summer of 2001, based on the negotiated arrangements with APS, the
22 price level in the new contract was reflective of forward prices for electricity
23 in July 2001, not past pricing.
24

25 Q. What does Dr. Rosen say about the potential termination of SSB and SSC of
26 the Old Contract?

27 A. Dr. Rosen correctly points out that APS could have cancelled SSB and SSC
28 by the end of 2003. He suggests that it is likely that Citizens could
29

1 purchase replacement power for the schedules at about the same price it
2 has averaged between 1995 and May 2000. He then concludes the new
3 contract price is too high since, by his calculations, the average
4 replacement price for SSB and SSC could be as high as 2.5 times the prior
5 levels before Citizens total costs for SSA plus market power would be
6 higher than the new contract price.
7

8 Q. Are Dr. Rosen's conclusions correct?

9 A. No. Dr. Rosen is again basing his conclusions here on the unsubstantiated
10 assertion that Citizens' interpretation of the Old Contract would prevail and
11 APS would be forced to abide by that interpretation. As Mr. Flynn
12 demonstrates in his rebuttal testimony, this is far from a certain outcome if
13 Citizens were to pursue this matter through legal channels.
14

15 Q. Does this conclude your rebuttal testimony?

16 A. Yes, it does.
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CITIZENS COMMUNICATIONS COMPANY

ARIZONA ELECTRIC DIVISION

DOCKET NO. E-01032C-00-0751

REBUTTAL TESTIMONY OF PAUL M. FLYNN

1 Q. Please state your name, present position, and business address.

2 A. My name is Paul M. Flynn. I am a member of the law firm of Wright &
3 Talisman, P.C. My address is 1200 G Street, N.W., Suite 600, Washington,
4 D.C., 20005.

5
6 Q. Please describe Wright & Talisman, P.C.

7 A. Since its founding nearly 50 years ago, Wright & Talisman has earned a
8 reputation as one of the nation's finest law firms specializing in federal and
9 state regulatory law and transactional counseling for regulated industries.
10 Wright & Talisman long has represented clients in electric utility and natural
11 gas pipeline rate, rulemaking, merger, complaint, certificate, and other
12 proceedings before the Federal Energy Regulatory Commission ("FERC")
13 and state public utility commissions, as well as in related appeals and other
14 litigation in federal and state courts. The firm also represented and
15 counseled clients regarding regulatory matters in antitrust, fair trade, and
16 contract litigation in various federal and state courts. Wright & Talisman's
17 energy practice is among the largest of its kind, and includes representation
18 of electric utilities and cooperatives, power pools, independent electric
19 transmission system operators, several major interstate natural gas and oil
20 pipeline companies, natural gas distribution companies, gas gathering,
21 processing, and storage companies, oil and natural gas producers, and
22 electric and gas marketing companies. The firm also represents clients in
23 hydroelectric licensing, exempt wholesale generator and cogeneration
24 matters. The firm's energy practice also includes counseling on antitrust
25 compliance, strategic planning and legislative lobbying. Wright & Talisman
26 also represent clients in litigation in federal and state courts and
27 administrative agencies in the Washington, D.C. area and throughout the
28 nation. The firm's members and associates have diverse experience in
29

1 litigation of, and counseling regarding, matters involving antitrust and
2 unfair trade issues (essential facilities and other monopolization claims,
3 tying, discriminatory pricing, and other matters), energy regulation, labor
4 law, customs tariff determinations, libel, employment discrimination,
5 constitutional law, Superfund liability and insurance, commercial and
6 government contracts, product liability, securities manipulation, RICO, ship
7 construction claims, commercial insurance coverage, business and
8 intentional torts, bankruptcy, international trade, trademark, class action
9 defenses, and general corporate issues. This experience has entailed all
10 phases of litigation, including multi-party, multi-district and other complex
11 matters.

12
13 Q. Please summarize your background and qualifications.

14 A. My professional career has been devoted to electric utility and natural gas
15 regulation and litigation since 1984. I have handled such matters as an
16 attorney with Wright & Talisman, P.C., since 1986. I have represented
17 investor-owned utilities, natural gas pipelines, independent system
18 operators, and their customers in matters before the FERC, state regulatory
19 commissions, and the federal courts of appeals and in federal antitrust
20 litigation. I have extensive experience in issues of open access
21 transmission by both gas and electric companies, including rates, tariff
22 development, business practice standardization, and construction and
23 connection of new facilities and new suppliers. In addition to numerous
24 tariff and rate proceedings, my work has included electric utility mergers,
25 major natural gas pipeline construction, and federal power marketing
26 agency proceedings, as well as telecommunications and hydroelectric
27 matters. I have been deeply involved in regulatory issues concerning the
28 establishment and operation of Independent System Operators,

1 representing one large ISO and the transmission owners that have
2 transferred functional control of their facilities to another large ISO. My
3 transactional experience includes involvement with both the project
4 financing and refinancing of a one-billion-dollar pipeline project and the
5 negotiation and review of numerous agreements for gas and electric
6 transmission. I have been a regular contributing author to the treatise
7 Regulation of the Gas Industry and I am a past chair of the Committee on
8 Gas Regulation of the Energy Bar Association. I hold degrees from Saint
9 Louis University (B.A., *magna cum laude*, 1982) where I was enrolled in Phi
10 Beta Kappa, and the George Washington University National Law Center
11 (J.D., 1985). I am a member of the District of Columbia and Maryland bars
12 and the bars of numerous United States Courts of Appeals.

13
14 Q. Please describe Wright & Talisman's relationship with Citizens
15 Communications Company.

16 A. Wright & Talisman was retained by Citizens to assist Citizens' Arizona
17 Electric Division with its dispute with Arizona Public Service Company
18 ("APS") concerning their 1995 Power Supply Agreement ("PSA"). Two
19 other senior Wright & Talisman attorneys, Mr. James McManus and Mr.
20 Arnold Podgorsky, and I took a team approach to addressing Citizens'
21 concerns. Mr. McManus has 26 years experience as a FERC practitioner and
22 Mr. Podgorsky has over 20 years of experience in commercial litigation.

23
24 Q. What is the purpose of your rebuttal testimony in this proceeding?

25 A. My testimony responds to portions of the direct testimony filed by
26 Commission Staff witness Lee Smith and Residential Utility Consumer Office
27 witness Richard A. Rosen.

1 Q. What portions of the direct testimony will you address?

2 A. My rebuttal testimony addresses the following issues raised by Ms. Smith
3 and Dr. Rosen:

- 4 - Whether Citizens was imprudent because it did not file a
5 complaint at FERC against APS on their contract dispute.
- 6 - Whether the level of detail in the System Incremental Cost
7 ("SIC") provisions of the PSA reflected imprudence on Citizen's
8 part.
- 9 - Whether Citizens was imprudent because it did not petition
10 FERC to impose price caps on western electricity market prices.
- 11 - Whether Citizens should have initiated a proceeding at this
12 Commission to resolve issues about the interpretation of the
13 PSA or APS's power supply planning.
- 14 - The legal and regulatory significance of FERC's approval of the
15 superseding power supply agreement executed by Citizens and
16 Pinnacle West Corporation in July 2001.

17

18 Q. Please describe the testimony of witnesses Smith and Rosen faulting
19 Citizens for not filing a complaint against APS at FERC.

20 A. Ms. Smith contends (at page 6 of her testimony) that Citizens, "to mitigate
21 the impact of ambiguous pricing provisions and the potential for very high
22 contract prices" should have "request[ed] that [FERC] assist in the
23 resolution of the dispute." She testifies (at page 31) that Citizens should
24 have gone to FERC prior to the summer of 2000 "to clarify the SIC dispute."
25 She acknowledges, however, that it is unlikely that FERC would have issued
26 an order on such a complaint by the summer of 2000. Ms. Smith also
27 testifies that Citizens should have filed a complaint at FERC during or after
28 the summer of 2000 "to clarify the definition of SIC" and that "a ruling in

29

1 favor of Citizens' interpretation of the SIC would have resulted in APS
2 refunding significant amounts to Citizens and changing its billing
3 methodology so that future bills would have been lower." However, Ms.
4 Smith does not testify that FERC actually would have ruled in Citizens'
5 favor, had such a complaint been brought.

6
7 Dr. Rosen similarly testifies (at page 2) that Citizens "should have filed a
8 complaint with [FERC] to determine the correct interpretation of the APS
9 contract." Dr. Rosen goes farther than Ms. Smith and testifies (at page 17)
10 that FERC would have found against APS in such a complaint.

11
12 Q. Was Citizens imprudent as they allege?

13 A. No. Citizens acted prudently in negotiating a new power supply agreement
14 with APS to eliminate the risk of continued high costs, rather than pursuing
15 litigation that could provide no immediate relief from high costs, would take
16 years to resolve, and ultimately was not likely to provide relief.

17
18 Q. Was FERC likely to find against APS on the inclusion of all of APS'
19 incremental costs in the charges to Citizens?

20 A. No. It is more likely that Citizens would have lost this issue at FERC. In
21 fact, we were concerned about FERC's reaction on this issue and therefore
22 focused our analysis for Citizens on the possibility of a federal district court
23 contract suit, rather than on a FERC complaint.

24
25 Q. Please explain.

26 A. In any FERC complaint proceeding, APS' ability to pass through its
27 purchased power costs to Citizens would be determined by the language of
28 the PSA and the FERC's policies and precedents on recovery of such costs.

1 The PSA language appears contradictory on this issue. However, we were
2 concerned that FERC, which approved the PSA in 1995, would rely on its
3 apparent policy of full incremental cost recovery from the sales customer
4 allegedly causing the cost increment, and could point to language in the
5 PSA supporting application of that policy in this instance. That concern
6 increased as our investigation of this matter progressed.
7

8 Q. What is the relevant language of the PSA?

9 A. The PSA had a number of provisions addressing the recovery of purchased
10 power costs from Citizens. Section 4.1 of the PSA defines "System
11 Incremental Cost" to include "the higher of either the incremental fuel cost
12 of the station or unit from which energy is obtained . . . ; or the cost of any
13 purchased power occurring simultaneously with sales under this Service
14 Agreement which were made for economic purposes and would not
15 otherwise be needed to effect transactions under this Service Agreement."
16 The term "System Incremental Cost" or "SIC" was used in the rate exhibits
17 to the three service schedules of the PSA to define the minimum rates, and
18 as a component of the maximum rates. SIC was also used in some cases
19 as part of the stipulated rate that was expected to fall between the
20 maximum and minimum rates. The rate exhibits for each of the three
21 service schedules also included, in addition to the minimum rate defined in
22 "Section I" and the maximum rate defined in "Section II," a "Section III"
23 stating that "Citizens shall also be responsible for purchased power costs,
24 and for any other costs incurred by APS in fulfilling its obligations for power
25 and energy under this Service Schedule [A, B, or C] which otherwise would
26 not have been incurred."
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1 Q. How do you interpret this language?

2 A. As reflected in Wright & Talisman's January 18, 2001, initial legal analysis
3 of the PSA (a copy of which was supplied to the ACC Staff and RUCO in
4 discovery in this case), we initially thought the better view of the original
5 intent of the parties was that only the costs of "economic" purchases could
6 be passed through to Citizens. In common industry parlance, "economy"
7 purchases are those made to displace higher cost units or purchases, as
8 opposed to "reliability" purchases that are made to ensure reliable service
9 to loads. We noted, however, that "the line between economic power
10 purchases and other types of purchases is not clear-cut" and that "APS will
11 try to argue that all of its purchases are for economic purposes, on the
12 theory that each of their transactions includes economic considerations." In
13 other words, the term "economic" begs the question of "economic relative
14 to what?" Applying the traditional meaning of the term "economy"
15 purchases in the context of a utility that has entered into purchases to
16 cover its loads raises more questions than it answers. Nonetheless, if the
17 term "made for economic purposes" is defined to limit the types of
18 purchased power costs that can be passed through to Citizens, then APS
19 could charge Citizens only for some, but not all, of its purchased power
20 costs. This interpretation would set up a conflict with the language of
21 Section III of each of the rate exhibits that states that Citizens shall "also"
22 be responsible for "purchased power costs," without any further limitation
23 stated, and for "any other costs" incurred by APS to sell power and energy
24 to Citizens "which otherwise would not have been incurred."

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1 Q. How might FERC have viewed this issue?

2 A. As reflected in our January 18, 2001, analysis, FERC in several cases has
3 required utilities to include a floor of "system incremental cost" in their
4 power sales to ensure that the utility would recover at least its incremental
5 costs of serving the sales customer and to prevent other customers served
6 under wholesale fuel adjustment clauses from subsidizing the sale. In fact,
7 Citizens' consultant Mr. Alan Heintz, a former senior member of FERC's
8 advisory staff, conveyed his firm view to Citizens and to Wright & Talisman
9 that FERC probably assumed when it approved the PSA that it allowed
10 recovery of all purchased power costs (not just "economic" purchases) and
11 that FERC likely would rely on Section III of the rate exhibits of the PSA to
12 support that position if it was challenged in a FERC complaint. Although the
13 January 18, analysis suggested some possible responses to this argument,
14 this concern about an adverse FERC reaction to the claim underlay our
15 entire approach to the dispute. The January 18 analysis itself is framed
16 less in terms of an evaluation of the prospects for success of a FERC
17 complaint than in terms of the likelihood for success of a claim for breach of
18 contract under Arizona law, with a focus on textual analysis of the PSA and
19 related or contemporaneous documents. The discussion of FERC
20 precedent, in fact, is presented in the context of possible "extrinsic
21 evidence" of FERC policy that APS might present to bolster its interpretation
22 of the PSA, rather than as a prediction of how FERC might rule. Frankly,
23 our underlying assumption, expressed several times in our discussions with
24 Citizens in December 2000 and early 2001, was that Citizens' chances were
25 better with a trial court, which would focus on the contract language and be
26 less influenced by FERC policy concerns.

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1 Q. Please describe Wright & Talisman's efforts for Citizens after the initial
2 analysis.

3 A. As shown by the documents provided in discovery to Staff and intervenors,
4 we proceeded to prepare a first draft of pleadings for possible litigation in
5 the U.S. District Court in Arizona, including a complaint, a motion for a
6 preliminary injunction, and supporting papers and affidavits. We also
7 interviewed current and former Citizens employees that were involved in
8 the negotiation of the PSA, assisted Citizens with a search for local Arizona
9 counsel, coordinated with the local counsel selected by Citizens, conducted
10 additional legal research, and engaged in an extensive search for an expert
11 witness that could authoritatively, knowledgeably, and persuasively present
12 Citizens' position in a court proceeding. In addition, we lent support to
13 Citizens' ongoing negotiation efforts with APS, by drafting talking points and
14 other high level summaries of the main arguments in Citizens' favor,
15 written from the perspective of an advocate for Citizens' position.

16
17 Q. What was the result of these efforts?

18 A. These additional efforts served to highlight the obstacles that Citizens faced
19 if it pursued a litigation strategy.

20
21 Q. Please explain.

22 A. Perhaps the most discouraging development was that the prospective
23 experts we interviewed that could speak with the most knowledge on these
24 issues disagreed with the basic conclusion in the January 18 memo, i.e.,
25 that the PSA allowed APS to pass through only a subset--and not all--of its
26 incremental purchases made to support service to Citizens. In addition, our
27 communications with Citizens' local Arizona counsel highlighted that civil
28 litigation in the Arizona federal district court would confront an extremely
29

1 crowded docket and take several years at best. Local counsel also
2 reinforced our conclusion that a preliminary injunction precluding APS's
3 interpretation of the contract--and thereby granting Citizen relief from high
4 charges during the pendency of the lengthy litigation--would be very
5 difficult to obtain in this lawsuit, as it would be essentially a contract suit for
6 which money damages usually are recognized as sufficient. Our interviews
7 with the current and former Citizens employees involved in the negotiation
8 of the PSA failed to produce the strong support that we would have desired
9 from the principal prospective witnesses on factual issues. Finally, our
10 discussions with prospective expert witnesses and Citizens' current
11 employees led us to conclude that the other possible claims briefly
12 mentioned in the January 18 memo (in addition to the contract breach
13 claim) probably were not tenable.

14
15 Q. Please describe your interviews with the prospective expert witnesses.

16 A. Although we interviewed several experts, the individuals with the most
17 knowledge of the issues raised were Mr. John Orecchio and Mr. Bob Tindall,
18 both of whom were, until recently, long-time employees and senior
19 managers of the FERC's litigation staff. Mr. Orecchio was involved in
20 electric regulation at the FERC for 30 years. From 1992 to 1998, he was
21 the Director of FERC's Division of Electric Rate Investigations, with overall
22 responsibility for every electric matter set for hearing. Mr. Tindall was the
23 long-time Chief of the West Branch of FERC's Division of Electric Rate
24 Investigations, responsible for all matters set for hearing that involved
25 utilities in the western U.S. Prior to the interviews, we provided each
26 gentleman copies of the PSA, including the service schedules and then-
27 effective rate stipulations, a 1994 letter of intent that preceded execution of
28 the PSA, the filing at FERC for approval of the 1995 PSA, copies of APS's
29

1 1994 Coordination Tariff, and APS's fuel adjustment clause from its
2 agreement with another wholesale customer. To avoid prejudicing their
3 opinions, we did not provide either of these prospective independent expert
4 witnesses with our January 18 analysis. We then interviewed each
5 prospective witness to discuss their opinions of the contract issues and
6 determine if either would make a suitable expert witness for Citizens. In
7 their separate interviews, both Mr. Tindall and Mr. Orecchio were
8 impressive in the depth of their knowledge of the regulatory and power
9 supply pricing issues and in their ability to explain those issues.
10 Unfortunately, both expressed the opinion that the PSA required Citizens to
11 pay for all of APS's incremental purchased power costs incurred to provide
12 service to Citizens, based on Section III of the rate exhibits and the FERC
13 policy that required certain wholesale customers to pay at a minimum the
14 full system incremental cost incurred to make the sale. In short, they
15 echoed the opinion previously given Citizens by Mr. Heintz.

16
17 Q. What conclusion did you and the other Wright & Talisman attorneys draw
18 from these interviews?

19 A. First, it greatly reinforced our concern that if Citizens filed a complaint with
20 FERC, it probably would lose the central issue in the contract interpretation
21 dispute. After discussing the matter with three former senior FERC staffers
22 that were close to FERC's thinking on this issue in the 1990's, the result
23 was three-for-three against the position in the January 18 memo on the
24 recovery of "economic" power purchases vs. all power purchases. If
25 Citizens lost that issue, then it would lose its main line of defense against
26 the high costs of power purchased by APS in western markets. Second, it
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1 highlighted our difficulty in locating an expert witness that could speak
2 authoritatively on the federal regulatory context of the contract—and
3 support our position—if Citizens took its dispute to district court.
4

5 Q. Please expand on the FERC policy issue highlighted by these experts.

6 A. The problem stems from FERC's approach to the fuel adjustment clause
7 ("FAC") for wholesale customers. APS' FAC is fairly typical. It charges
8 wholesale requirements customers for the utility's purchased power costs to
9 the extent not collected from off-system sales customers. By operation of
10 the FAC, if APS incurs additional purchased power costs to serve Citizens'
11 loads and does not recover those costs from Citizens, then they will be
12 recovered from the APS customers using APS' fuel adjustment clause.
13 Therefore, if APS can charge Citizens only for the costs of the purchases
14 that are less than the cost of running APS' own units, then the FAC
15 customers will bear the costs of APS' incremental purchases that are more
16 expensive than running APS' own units. In short, FERC's policy is to protect
17 FAC customers from subsidizing such incremental purchased power costs.
18

19 Q. Witness Smith also faults Citizens for not raising at FERC other contract
20 issues, including (at pages 36-37) the specific method of assigning system
21 incremental cost to Citizens and the period of time over which the minimum
22 rate calculation should be compared to the stipulated rate calculation.
23 Witness Rosen also faults Citizens for not litigating APS' charges under the
24 "base load" portion of Schedule A. Taking these issues in turn, how did the
25 experts you interviewed characterize Citizens' "increment" for purposes of
26 assigning APS' power purchase costs?

27 A. Both of these prospective expert witnesses would have placed Citizens next
28 in line after APS' bundled retail and wholesale-requirements customers.
29

1 Because Citizens is by far APS' largest wholesale customer, this effectively
2 placed Citizens' load on the margin whenever APS had to go to the market
3 to serve its combined bundled retail, wholesale requirements, and Citizens
4 loads. While the precise method APS used to calculate SIC was not clear, if
5 APS placed Citizens after APS' retail and wholesale requirements loads, that
6 probably was enough to expose Citizens to the level of market prices that
7 were passed through, given APS' demand profile and supply portfolio.
8 Based on my discussions with Citizens' consultant, Mr. Heintz, he agreed
9 that Citizens would probably be placed after APS' bundled retail and
10 wholesale-requirements customers if Citizens lost the fundamental contract
11 issue and was thereby exposed to APS' high-cost market purchases. In
12 general, unless a specific purchase is identified as being on behalf of a
13 particular incremental customer, that incremental customer is likely to be
14 subjected to paying for the most expensive purchases in the supply stack
15 that correspond to its position in the demand stack, so long as that
16 purchase was made in anticipation of combined loads that included that
17 incremental customer. Because Citizens had a multi-year power sales
18 agreement with APS, APS probably would have substantial leeway at FERC
19 to argue that its purchases, although made at various different times,
20 nonetheless were in anticipation of service to combined loads that included
21 Citizens. In all of our extended discussions with Mr. Heintz about "supply
22 stack" and "demand stack" complexities, we always ended with the mutual
23 conclusion that it all turned on how FERC was likely to decide the
24 fundamental issue of whether Citizens could be required to pay for full SIC
25 or only for "economic" purchases. Therefore, it is doubtful whether Citizens
26 could recoup much if it had pursued, as a fallback issue, the details of how
27 APS calculated SIC, assuming *arguendo* that APS could include its high-cost
28 market purchases.

1 Q. Even assuming that APS could properly pass through to Citizens APS' costs
2 of market purchases as part of the rate floor in the PSA, the January 18
3 memo raises a question about the time period over which that floor rate is
4 calculated. Was this a promising litigation issue for Citizens?

5 A. This was not a very attractive issue on which to mount a successful lawsuit.
6 The contract does not say whether the floor rate was calculated monthly,
7 annually, or over the life of the contract. If the floor rate was to be
8 calculated over the life of the contract, then APS could only charge Citizens
9 for the full incremental cost to the extent it exceeded the amounts paid by
10 Citizens pursuant to the stipulated rates over the life of the contract.
11 However, the extrinsic evidence does not favor this sort of interpretation.
12 As noted in the January 18 memo, when APS filed the PSA with FERC for
13 approval, it included an illustration of the operation of the floor and ceiling
14 rates with monthly calculations. Subsequently, we reviewed the APS
15 invoices and saw that APS' consistent billing practice appeared to be a
16 monthly calculation. Mr. Orecchio, after reviewing the contract and related
17 materials, also advised us that he thought the calculation was properly
18 performed on a monthly basis.

19
20 Q. The January 18 memo and the briefing materials prepared for Citizens' use
21 in the APS negotiations also emphasize that Citizens had an argument
22 against APS charging the costs of market purchase for the "base load block"
23 of service under Service Schedule A. Dr. Rosen (at pages 16-17) also notes
24 this issue. Would this have been a good issue on which to build a complaint
25 against APS?

26 A. The Schedule A base load issue was especially frustrating. There is
27 evidence that both parties intended and assumed that the first 100 MW of
28 service under Schedule A, for which Citizens paid a significant demand
29

1 charge as part of the stipulated rates, would be based on the embedded
2 costs of APS' generating units and therefore would be charged only for the
3 energy costs of APS' own units. The unavoidable problem, however, was
4 the language of Schedule A and the rate exhibit, which set forth minimum
5 and maximum bounds for the stipulated rates, included SIC in the minimum
6 charge, and additionally provided, in the standard "Section III" to all of the
7 rate exhibits, that Citizens was "also" responsible for "purchased power
8 costs." We were not able to develop a strong argument for reading away
9 the minimum rate requirement or the language of Section III.

10
11 Q. Based on this information, what did you advise Citizens about the prospects
12 for success on the merits of any FERC or district court claim?

13 A. We were in touch with Citizens on a continual basis throughout the first half
14 of 2001, and kept them apprised of the above developments. More
15 generally, we told them that their chances of success in litigation were
16 likely to be significantly less than the "better than even" odds cited in our
17 January 18 memo. Moreover, when Mr. Daniel McCarthy, Citizens' Vice
18 President, told me in May that he planned a renewed effort to settle with
19 APS, I encouraged him to do so, advising that I thought settlement, rather
20 than litigation, would be in their best interests.

21
22 Q. Aside from the chances of success on the merits, how did timing issues
23 affect the consideration of whether to settle or litigate?

24 A. The timing issues were significant. High prices continued under the PSA
25 into the winter of 2000-2001. The general expectation throughout the first
26 half of 2001 was that the supply-demand imbalance in California that had
27 shocked the western markets would not be resolved overnight, and that the
28 Arizona Electric Division, which was already operating to a very substantial
29

1 degree on a negative cash flow basis, was threatened with high prices
2 under the PSA for the summer of 2001 and for the foreseeable future
3 thereafter. Citizens' witness, Dr. William E. Avera, addresses in greater
4 detail the market perceptions in 2001 and Citizens' reasonable anticipation
5 of continuing increased high charges under the PSA. There was very little
6 chance that litigation could provide any immediate or even near-term relief
7 for Citizens from the threat of high costs under the PSA. As discussed
8 above, district court litigation in Arizona was likely to take, under the best-
9 case scenario, at least a year or two before it could even go to trial. A final
10 decision and mandate would be some considerable time after that.
11 Moreover, the best-case scenario was unlikely in this case, because there
12 was a good chance that if we filed suit in Arizona, then APS would seek to
13 have the case moved to FERC on primary jurisdiction grounds. A trial court
14 faced with a crowded docket and a complex case raising arcane power
15 pricing and FERC policy issues likely would put the case on hold while it
16 waited for FERC to decide whether to take the case. In the meantime,
17 Citizens and its customers would be exposed to continuing high prices
18 under the PSA. As discussed above, a court was unlikely to issue a
19 preliminary injunction precluding APS from charging Citizens for high-cost
20 market purchases, as the claim before the court would essentially be a
21 contract breach suit for which money damages normally are viewed as
22 sufficient.

23
24 Q. What were the timing considerations for a FERC complaint?

25 A. As discussed above, the prospects for success at the FERC were not good.
26 Moreover, had Citizens filed a complaint at FERC, the timing considerations
27 would not be much more attractive than with a district court. In the first
28 place, FERC would have to decide whether to take the case, or instead

1 characterize it as a billing dispute that the parties should resolve in court.
2 To have any hope of past relief, Citizens would have to characterize the
3 dispute as one in which APS had violated the terms of the PSA on file with
4 FERC. However, FERC often declines to exercise jurisdiction over claims
5 that the billing conflicts with the contract, referring the parties instead to
6 court remedies. Had the FERC eventually decided to take the case, it
7 almost certainly would have been set for an evidentiary hearing, to resolve
8 the factual issue of the parties' intent under the contract. Under FERC's
9 "tracking" system for hearings, such a complaint likely would have been put
10 on a schedule anticipating an administrative law judge's initial decision
11 about a year after the FERC's order deciding to take the case and set it for
12 hearing. However, FERC's tracking system sets deadlines for ALJ decisions,
13 but not for its own decisions. Thus, there is no guarantee when FERC
14 would act on such a complaint; I have seen complaint cases languish for
15 years awaiting a FERC decision.

16
17 Moreover, even after a FERC or district court decision, the unsuccessful
18 party would likely exercise its right to appeal, which would further delay a
19 final outcome in the dispute by another year or two, at least.

20
21 Q. Did you communicate these timing concerns to Citizens?

22 A. Yes, through our various discussions in 2001.

23
24 Q. What, if any, are the cost implications of these timing considerations?

25 A. In addition to the costs of the litigation, Citizens was experiencing
26 unrecovered costs on the order of \$50 million each year, based on its
27 experience in 2000. Citizens saw itself in 2001 as facing unrecovered costs
28 of that magnitude, with no carrying cost compensation, for the next several
29

1 years if it chose to litigate. In addition to the inequity and impracticability
2 of Citizens subjecting itself to that level of cost exposure, the situation
3 raised significant issues of intergenerational equity for Citizens' ratepayers.
4 While a cost amortization as proposed in Citizens' original and amended
5 applications departs from strict generational cost recovery, that
6 consideration is offset in those proposals by the avoidance of rate shock.
7 By contrast, an outright deferral for four or five years before costs even
8 *begin* to be recovered raises substantial concern that future customers are
9 paying to an unjustifiable degree for costs incurred by past customers.
10

11 Q. What action did Citizens take based on the information you provided about
12 the prospects for success, and timing of, litigation against APS?

13 A. As discussed by Citizens' witness, Mr. Sean Breen, Citizens determined that
14 negotiation to engage APS in a solution to the problem of the PSA and high
15 purchased power costs was the most prudent course to protect Citizens and
16 its ratepayers from continued high costs. Litigation, by contrast, would not
17 have provided any near-term relief and undoubtedly would have forced a
18 deferral of any serious negotiating efforts.
19

20 Q. Ms. Smith testifies (at page 14) that the SIC provisions of the PSA lack
21 detail and that this reflects imprudence on Citizens' part. Do you agree?

22 A. No. The SIC provisions of the PSA are essentially the same as those in
23 previous power supply agreements between APS and Citizens. Moreover,
24 these SIC provisions are similar to those that we found on file with FERC for
25 other utilities while we were conducting our legal analysis for Citizens.
26 Therefore, the level of detail in the SIC provisions of the PSA is standard for
27 the industry.
28
29

1 Q. Your testimony above concludes that Citizens probably would not succeed
2 in a complaint on the issue of APS' inclusion of high-cost market purchases
3 in the PSA. Does this mean that Citizens was imprudent for entering into
4 the PSA?

5 A. Absolutely not. In the first place, when Citizens and APS negotiated the
6 PSA in 1994, neither party expected that APS would incur substantial spot
7 market purchased power costs in order to meet its Citizens load obligations.
8 And when this dispute came to the fore in 1999 and 2000, Citizens
9 reasonably believed it was protected from these charges by the language of
10 the contract. Perhaps the best evidence of the reasonableness of Citizens'
11 understanding of the contract is the fact that we initially concluded that
12 Citizens had a better than even chance of success on a contract breach
13 claim based on the language of the contract.

14
15 Q. Dr. Rosen argues (at page 2) that Citizens was imprudent because it did
16 not petition FERC "to get price caps or other wholesale price mitigation
17 measures in place throughout the West as quickly as possible after May
18 2000." He expands on this argument at page 7 of his testimony. Is this a
19 reasonable accusation?

20 A. No. The suggestion that Citizens somehow bears responsibility for the level
21 of electric power market costs in the west in 2000-2001 because it did not
22 induce FERC to cap those prices is ludicrous. Citizens is one of the smallest
23 investor-owned electric utilities in the southwest and the general level of
24 electric prices in that region is far beyond Citizens' ability to influence.
25 Moreover, given the number, size, and political standing of the other
26 entities that already were raising this issue at the FERC in 2000, the
27 addition of Citizens' voice would have been very unlikely to cause FERC to
28 take any additional or earlier action than it ultimately took. All three major
29

1 investor-owned utilities in California, supported by the California Public
2 Utilities Commission, asked FERC in August 2000 to cap the bid prices in
3 the California market, but FERC refused to do so, instead instituting
4 investigations and only later instituting various forms of "soft caps" and
5 price justification requirements. In any event, APS, as a purchaser in the
6 affected markets, already is a participant in the western market refund
7 proceedings ordered by FERC in Docket Nos. EL00-95-000, et al. To the
8 extent APS obtains any refunds for its purchases made during the term of
9 the PSA, then APS will need to adjust the past billings to Citizens.

10
11 Q. Dr. Rosen also argues (at page 2) that Citizens was imprudent because it
12 did not petition this Commission "to institute a docket to determine if APS'
13 supply planning was prudent in light of its firm contractual obligations to
14 Citizens." He similarly argues (at page 8) that Citizens should have "filed a
15 request with the ACC to get the ACC's interpretation of the contract." Is it
16 appropriate to fault Citizens for not petitioning this Commission to interpret
17 the PSA or address the prudence of APS' fulfillment of its wholesale power
18 obligations?

19 A. No, because this Commission does not have authority over APS' wholesale
20 contract with Citizens, and cannot resolve the reasonableness of APS'
21 charges to Citizens under the PSA. The PSA is a sale of power for resale in
22 interstate commerce that was on file with FERC and that was subject to
23 FERC's exclusive jurisdiction under the Federal Power Act. Only the FERC
24 can determine whether the charges under that contract are "just and
25 reasonable" within the meaning of the FPA and therefore lawful. The ACC
26 had no authority to order any changes to the PSA, nor is the ACC a court of
27 general jurisdiction that could order equitable or monetary relief on any
28 claim that Citizens was billed in a manner that conflicted with the contract.

1 Dr. Rosen's observation that "FERC does not usually regulate supply
2 planning even for the provision of wholesale contracts" (at 12), even if true,
3 does not create a regulatory vacuum that this Commission is authorized to
4 fill. FERC has exclusive jurisdiction to decide whether APS' charges to
5 Citizens were just and reasonable, including the subsidiary question of
6 whether those charges were inflated by imprudent conduct. In short,
7 Citizens properly focused its litigation analysis on the prospects for relief
8 from either the FERC or the courts. In the January 18 memo, we briefly
9 noted the possibility of raising at the ACC any issues that could be
10 developed about APS' compliance with the ACC's rules on separation of
11 monopoly and competitive services offered by electric utilities. However,
12 we noted that "it is not clear how any remedy for conduct that violates
13 these rules (even if proved) would benefit Citizens." Because this did not
14 provide a clear path to any significant relief, it was not a priority.
15

16 Q. Dr. Rosen speculates (at page 25) that the new power purchase contract
17 between Citizens and Pinnacle West Corporation is not "just and
18 reasonable" under the Federal Power Act. What is your response?

19 A. His speculation is irrelevant. FERC accepted the contract, without
20 suspension or hearing, and allowed it to become effective on June 1, 2001.
21 Therefore, the rates paid by Citizens under that contract are the lawful
22 rates and may not be set aside by any other body. Only the FERC can
23 change those rates, and then only prospectively (at the earliest, 60 days
24 after notice of a FERC or third-party challenge under section 206 of the
25 FPA) and only if FERC finds on the basis of substantial evidence that the
26 existing rate is unjust and unreasonable and the proposed replacement is
27 just and reasonable.
28
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1 Q. Does that conclude your rebuttal testimony?

2 A. Yes, it does.

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BEFORE THE ARIZONA CORPORATION COMMISSION

**IN THE MATTER OF THE APPLICATION OF)
THE ARIZONA ELECTRIC DIVISION OF)
CITIZENS COMMUNICATIONS COMPANY)
TO CHANGE THE CURRENT PURCHASED)
POWER AND FUEL ADJUSTMENT CLAUSE)
RATE, TO ESTABLISH A NEW PURCHASED)
POWER AND FUEL ADJUSTMENT CLAUSE)
BANK, AND TO REQUEST APPROVED)
GUIDELINES FOR THE RECOVERY OF COSTS)
INCURRED IN CONNECTION WITH ENERGY)
RISK MANAGEMENT INITIATIVES.)**

REBUTTAL TESTIMONY

OF

WILLIAM E. AVERA

On Behalf of

The Arizona Electric Division of Citizens Communications Company

**FINCAP, Inc.
Financial Concepts and Applications, Inc.
3907 Red River
Austin, Texas 78751
(512) 458-4644**

March 1, 2002

REBUTTAL TESTIMONY OF WILLIAM E. AVERA

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Schedule WEA-1 – Overall Rate of Return

Schedule WEA-2 – Coverage Ratio

APPENDIX A – Qualifications of William E. Avera

A. Introduction and Qualifications

1 **Q. Please state your name and business address.**

2 A. William E. Avera, 3907 Red River, Austin, Texas, 78751.

3 **Q. By whom are you employed and in what capacity?**

4 A. I am a principal in Financial Concepts and Applications, Inc. (FINCAP), a firm
5 engaged in financial, economic, and policy consulting to business and
6 government.

7 **Q. Describe your educational background, professional qualifications, and
8 prior experience.**

9 A. I received a B.A. degree with a major in economics from Emory University. After
10 serving in the U.S. Navy, I entered the Ph.D. program in economics at the
11 University of North Carolina at Chapel Hill. Upon graduation, I joined the faculty
12 at the University of North Carolina and taught finance in the Graduate School of
13 Business. I subsequently accepted a position at the University of Texas at Austin
14 where I taught courses in financial management and investment analysis. I then
15 went to work for International Paper Company, Inc. in New York City as Manager
16 of Financial Education, a position in which I had responsibility for all corporate
17 education programs in finance, accounting, and economics.

18 In 1977 I joined the staff of the Public Utility Commission of Texas (PUCT)
19 as Director of the Economic Research Division. During my tenure at the PUCT, I
20 managed a division responsible for financial analysis, cost allocation and rate
21 design, economic and financial research, and data processing systems, and I
22 testified in a number of cases on a variety of financial and economic issues.
23 Since forming FINCAP in 1979, I have participated in a wide range of analytical
24 assignments involving utility-related matters on behalf of utilities, industrial
25 customers, municipalities, and regulatory commissions. I have previously
26 testified before the Federal Energy Regulatory Commission (FERC), the Federal
27 Communications Commission (FCC), the Surface Transportation Board (and its
28 predecessor, the Interstate Commerce Commission), the Canadian Radio-

1 Television and Telecommunications Commission, and courts, legislative
2 committees, and regulatory agencies in 28 states.

3 With the approval of then-Governor George W. Bush, I was appointed by
4 the PUCT to the Synchronous Interconnection Committee, which was formed to
5 advise the Texas legislature on the costs and benefits of connecting Texas to the
6 national electric transmission grid. Currently, I am serving as an outside director
7 of Georgia System Operations Corporation, the system operator for electric
8 cooperatives serving Georgia and parts of Alabama and Florida. A resume
9 containing the details of my experience and qualifications is attached as
10 Appendix A.

11 I have also served as Lecturer in the Finance Department at the University
12 of Texas at Austin, and taught graduate courses at St. Edward's University for
13 twenty years. In addition, I have lectured on economic and regulatory programs
14 sponsored by universities and industry groups. I have taught in hundreds of
15 educational programs for financial analysts in seminars sponsored by the
16 Association for Investment Management and Research, the Financial Analysts
17 Review, and local financial analyst societies. These programs have been
18 presented in Asia, Europe, and North America, including the Financial Analysts
19 Seminar at Northwestern University. I hold the Chartered Financial Analyst
20 (CFA) designation and have served as Vice President for Membership of the
21 Financial Management Association. I have also been elected as an officer or
22 director of various other professional organizations and societies.

23 **Q. What is the purpose of your rebuttal testimony in this case?**

24 A. This proceeding concerns the Arizona Electric Division of Citizens
25 Communications Company's (AED or the Company) application for authority to
26 recover certain amounts through its Purchased Power Fuel Adjustment Clause
27 (PPFAC). The AED is principally requesting recovery of the under-collected
28 PPFAC bank balance, recovery of carrying charges on the accumulated but
29 unrecovered balance of power supply costs, and a change in the PPFAC rate to
30 reflect its new power supply contract with Pinnacle West Capital Corporation
31 (PWCC).

1 My purpose here is to respond to the testimonies of Ms. Lee Smith on
2 behalf of the Arizona Corporation Commission (ACC or the Commission) Staff
3 and Dr. Richard A. Rosen on behalf of the Arizona Residential Utility Consumer
4 Office (RUCO).

5 **Q. Please summarize the basis of your knowledge and conclusions**
6 **concerning the issues to which you are testifying in this hearing.**

7 A. To prepare my testimony, I used information from a variety of sources that would
8 normally be relied on by a person in my capacity. I obtained information relevant
9 to the organization, finances, and operations of the AED through discussions with
10 management and from my review of various documents relating to the AED,
11 including financial reports and prior regulatory proceedings and orders. In
12 connection with this filing, I also reviewed information relating to the electric
13 power industry, including bond rating agency reports, financial filings, and various
14 articles in the trade press. These sources, coupled with my experience in the
15 fields of finance and utility regulation, enabled me to acquire a working
16 knowledge of the AED and formed the basis for my conclusions.

17 **Q. What were Ms. Smith's findings and recommendations?**

18 A. Ms. Smith found a lack of clarity in the Power Service Contract (PSA) between
19 the AED and Arizona Public Service Company (APS) in effect from 1995 through
20 May 2001 (Old Contract). Because the AED, in her opinion, failed to address
21 properly the overbilling and did not take sufficient action to mitigate "reasonably
22 foreseeable" price risks, she recommended that the AED should be denied the
23 opportunity to recover \$7 million of unrecovered power costs. Ms Smith also
24 proposed that the AED be allowed to collect \$49 million accumulated in the
25 PPFAC bank only after it pursues overbilling issues against APS. As an
26 additional penalty, Ms. Smith would deny the AED any carrying charges over the
27 six-year period power costs are to be recovered. Ms. Smith recommended that
28 the PPFAC be increased to incorporate the impact of the PSA between the AED
29 and PWCC effective June 1, 2001 (New Contract).

1 **Q. What were Dr. Rosen's findings and recommendations?**

2 A. Dr. Rosen concluded that approximately half of the charges made by APS under
3 the Old Contract were not reasonable and that the AED did not take appropriate
4 steps to mitigate its PPFAC bank balance between May 2000 and May 2001.
5 Further, Dr. Rosen finds that the New Contract is too expensive when compared
6 to historical prices and subsequent agreements by PWCC. Dr. Rosen
7 recommends disallowing approximately \$70 million of the PPFAC bank balance¹
8 with the remainder collected over two years with six- percent interest accruing on
9 the unamortized balance. Because he is skeptical of whether the New Contract
10 is just and reasonable, Dr. Rosen recommends that the PPFAC not be increased
11 to reflect the impact of prices under the AED's current power service agreement
12 with PWCC.

B. Summary and Conclusions

13 **Q. Please summarize your conclusions.**

14 A. The conclusions of my rebuttal testimony are summarized below. Contrary to the
15 testimony of Ms. Smith and Dr. Rosen:

- 16 • *The AED pursued the most direct and logical course to insulate the*
17 *Company and ratepayers from energy market volatility by resolving*
18 *outstanding differences with APS prior to the unexpected surge in*
19 *wholesale power prices that occurred in the summer of 2000;*
- 20 • *The dislocations that swept through wholesale power markets were*
21 *unprecedented in their magnitude and duration. The crisis that began*
22 *in summer 2000 was unanticipated by the entire electric utility industry*
23 *in the West, including regulators, politicians, and the electric utilities*
24 *themselves;*
- 25 • *When the AED became aware that these extreme power market*
26 *conditions had apparently caused APS to ignore the understanding*
27 *reached in May 2000, it reacted swiftly by hiring consultants and*
28 *attorneys to examine the related billing issues and evaluate alternative*
29 *actions to deal with the dispute;*

¹ Dr. Rosen suggests that the amount be refined based on further analysis.

- 1 • *The AED's actions were completely consistent with its obligation to*
2 *continue to supply a reliable source of power to customers, even while*
3 *absorbing the impacts of a massive cash-flow drain. The AED was*
4 *highly motivated to resolve its dispute with APS in a timely and*
5 *effective manner due to the drastic impact of the mounting power cost*
6 *deferrals on its financial viability. However, options were limited by the*
7 *ongoing volatility and uncertainties in the power markets, as well the*
8 *fact that it was bound by an existing contract with APS;*
- 9 • *There were significant short-comings and pitfalls associated with the*
10 *alternative actions that Ms. Smith and Dr. Rosen, in hindsight, suggest*
11 *the AED should have undertaken;*
- 12 • *Consistent with the importance placed on price stability by the ACC*
13 *and Staff, the AED negotiated a new power supply agreement that*
14 *completely insulated the Company and its ratepayers from further risk*
15 *of the vagaries of energy market prices;*
- 16 • *Aside from second-guessing the AED's actions based on the benefit of*
17 *perfect hindsight, Staff and RUCO entirely failed to consider the*
18 *implications of their recommendations on the financial viability of the*
19 *AED. As demonstrated in my testimony, their proposals are*
20 *inconsistent with the AED's past treatment as a stand-alone, low-risk*
21 *utility and would spell financial disaster for the Company.*

22 Under the circumstances, the AED has tried to play by the existing regulatory
23 rules by ensuring reliable service while pursuing a reasonable course of conduct
24 given its circumstances. Staff and RUCO's recommendations are predicated on
25 second-guessing the AED's behavior with the benefit of perfect hindsight and
26 assuming that the AED could have pursued options that were not reasonably
27 available at the time.

28 **Q. How is your rebuttal testimony organized?**

29 A. The remainder of my rebuttal testimony is organized into five sections. Section C
30 describes the market conditions leading to the unprecedented escalation in
31 wholesale power prices and demonstrates that it is unreasonable to fault the
32 AED for not anticipating the dramatic increase in prices charged by APS
33 beginning in May 2000. Section D reviews the actions taken by the AED in
34 responding to escalating power costs and demonstrates that they were
35 consistent with prevailing regulatory policy and the AED's specific circumstances.
36 Section E examines the actions that Ms. Smith and Dr. Rosen claim the AED
37 should have taken to mitigate against higher power costs and shows that they

1 would not have worked to the advantage of the AED's customers. Section F
2 demonstrates that the New Contract negotiated by the AED was consistent with
3 its responsibilities to its customers and the market realities prevailing at the time.
4 Finally, Section G examines the implications of the Staff and RUCO
5 recommendations and demonstrates that accepting their proposals would
6 devastate the AED's financial integrity.

C. Impact of Power Market Conditions

7 **Q. What is the underlying premise of Ms. Smith's recommendations?**

8 A. Ms. Smith's criticism of the AED's response to higher power bills largely rests on
9 the presumption that the unprecedented conditions in wholesale power markets
10 that occurred in the summer of 2000 were vividly apparent late in 1999.

11 **Q. Please describe the power market conditions that ultimately led the AED's**
12 **PPFAC bank balance to balloon.**

13 A. As a result of a confluence of factors, conditions in the wholesale power markets
14 changed radically in the summer of 2000, leading to unprecedented price
15 volatility. First, power shortages in California, coupled with a failed deregulation
16 plan, led to precipitous spikes in wholesale market prices for electricity.² The
17 compound effect of a fast-growing economy and high summer temperatures
18 created a rising need for power that was not accompanied by a corresponding
19 increase in the state's generating capacity. Inadequate generation has a
20 predictable result: where demand exceeds supply, prices rise in the wholesale
21 market. Structural problems with the state's transmission grid and apparent
22 flaws in California's market structure also exacerbated the upward price pressure
23 attributable to the imbalance between demand and supply. For example, retail

² There is considerable debate among industry participants regarding the factors most responsible for the ongoing energy crisis in California. This discussion highlights the explanations most commonly cited in articles such as "Who Turned the Lights Out?", *Fortune* (February 5, 2001), "For Power Suppliers, The California Market Loses Its Golden Glow", *THE WALL STREET JOURNAL* (January 25, 2001), and "California's Power Crisis: A state of gloom", *The Economist* (January 20, 2001).

1 electric service providers were precluded from entering into long-term contracts
2 for power that would have allowed them to insulate against significant price
3 movements, with all wholesale power being bought at the highest marginal price
4 through the centralized power exchange.

5 Because California depends on imports to meet approximately 25 percent
6 of its electricity needs, the chaotic conditions within the state spilled over into
7 power markets throughout the Western U.S. Utilities from Washington to Arizona
8 experienced the rapid and unprecedented increases in wholesale electric prices
9 to varying degrees. Higher fuel costs for thermal generation and extreme
10 weather only added "fuel to the fire". Because of the lack of surplus generation,
11 utilities were forced to run older, less efficient gas-fired facilities, while new
12 generation facilities also rely predominantly on natural gas. As a result, demand
13 for natural gas increased while deliverability remained largely static.³ Coupled
14 with the burden of meeting air conditioning load spurred by the intense heat
15 experienced over much of the Southwest during the summer of 2000 and greater
16 heating needs due to record cold weather during the winter of 2000/2001, this led
17 to sharply higher fuel costs for gas-fired generating facilities. In addition, utilities
18 in the Northwest, which depend heavily on hydroelectric generation, were also
19 saddled with the effects of record-setting low precipitation and environmental
20 constraints. Reduced stream flows curtailed hydroelectric output and caused
21 many utilities to turn to the market for replacement power precisely when supply
22 was short and prices were reaching record highs.

23 **Q. Is it reasonable to expect that the AED could have accurately foreseen**
24 **these events, as Ms. Smith alleges?**

25 A. No. The unprecedented and dramatic volatility that was experienced in Western
26 wholesale electricity markets beginning in May 2000 came as a shock to the
27 //

³ For example see "Incentives to Burn: How Federal Policies, Industry Shifts Created A Natural Gas Crunch", THE WALL STREET JOURNAL (January 3, 2001).

1 entire utility industry and others affected by these events. While participants
2 recognized that seasonal factors or unanticipated events, such as the loss of a
3 key generating unit, might contribute to fluctuations in wholesale prices, there
4 was no widespread anticipation of the chaotic conditions that began abruptly in
5 the summer of 2000. As *Fortune* summed up:

6 [E]verything worked very much as planned until May, when it
7 stopped working.

8 In May, as Southern Californians sat happily under their air
9 conditioners, the price of power skyrocketed. The average
10 wholesale price of one megawatt-hour of electricity went from \$30
11 in early May to \$146 in June, spiking at peak times to more than
12 \$1,000. It stayed high through the hot summer and, to everyone's
13 shock, stayed high even as energy use fell in the winter...⁴

14 It is clear that the unforeseen and prolonged spike in wholesale electricity prices
15 in the West was beyond the contemplation of all market participants. In its
16 *Annual Energy Outlook 2000* published in December 1999, the Energy
17 Information Administration (EIA) noted that periods of high prices would be
18 limited to only a few hours during the peak season and would have a relatively
19 small impact on electric prices.⁵ EIA concluded that competition would reduce
20 the cost of electric generation, with electric prices expected to fall in real terms
21 through 2020.

22 The variability in short-term market prices ultimately experienced in the
23 West bore no resemblance to fluctuations encountered in the past. Given the
24 sharp departure from anything resembling past experience, these price changes
25 were beyond any reasonable expectations of market participants and impossible
26 to predict. Utility planners and other market participants were blindsided by the
27 magnitude and wide reach of the price spikes in California. An *Electric Week*
28 report concerning the impact on Oregon exemplifies the experience of other
29 Western utilities:

⁴ "Who Turned The Lights Out?", *Fortune* (February 5, 2001).

⁵ "Annual Energy Outlook 2000", Energy Information Administration (December 1999).

1 In May and June, planners for Portland General Electric anticipated
2 prices ranging from \$35 to \$80/MWh on the open market. But
3 prices skyrocketed to levels as high as \$1,000/MWh and have
4 leveled off at about \$150/MWh, according to the OPUC.⁶

5 Similarly, at a May 17, 2000 ACC workshop on summer preparedness,
6 representatives from Arizona's utilities apparently had no grave concerns over
7 the upcoming state of wholesale electric markets. Arizona Public Service
8 Company (APS) anticipated no severe difficulties in meeting firm load
9 requirements. While APS noted the potential impact of forest fires on
10 deliverability, it made no mention of events in California. Similarly, the Salt River
11 Project concluded that "generation is ready and purchases are adequate to meet
12 the forecasted year 2000 demand".⁷ Again, the potential for extreme price
13 volatility or power shortages in the West was not a factor included in their
14 presentation. The Western Area Power Administration (WAPA), which markets
15 over 10,600 MW of federal hydropower in the Western states, indicated in its
16 responses to a survey by the North American Reliability Council (NERC)
17 provided to the ACC that:

18 [I]arge scale occurrences of unusual or unexpected load growth is
19 very limited in volume and recent Summer and Winter peaks and
20 loads have been manageable with existing resources.⁸

21 In response to NERC's request to:

22 Provide any conditions or information for the upcoming summer
23 that influenced your area assessment.⁹

24 WAPA responded that:

25 There are no unusual or extreme conditions that have modified
26 [WAPA's] assessment for Summer 2000.¹⁰

⁶ "Ore. Regulators to Take a Second Look at Deregulation in Light of High Prices", *Electric Week*, p. 7 (August 7, 2000).

⁷ Salt River Project, *SRP Summer Preparedness*, presented to the Arizona Corporation Commission (May 17, 2000).

⁸ Western Area Power Administration, *Summer Status, Attachment* (May 17, 2000).

⁹ *Ibid.*

1 Utilities were not the only stakeholders to be blindsided by events in
2 California and their far-reaching impact. Less than a year before Pacific Gas &
3 Electric Company (PG&E) declared bankruptcy, The Value Line Investment
4 Survey (Value Line) advised investors on May 19, 2000 that:

5 On balance, we rate this financially strong company an average
6 electric utility holding.¹¹

7 Conspicuously absent from Value Line's report was any mention of a looming
8 power crisis facing California's largest utility. Indeed, even after the initial market
9 unrest, there was considerable debate regarding the severity of the events and
10 the likely course for future wholesale electric prices. In arguing against lowering
11 price caps in the California market, for example, the Chairman of the California
12 ISO Board urged moderation, arguing that "it is not like all hell is breaking
13 loose".¹² In a synopsis of the impact of California's energy crisis on the West,
14 The Wall Street Journal noted the widely held belief that the high prices
15 experienced during the summer months would moderate and that, once again,
16 the consensus opinion was proved wrong:

17 Many expected the power crunch and prices to ease this winter,
18 when California demand typically slackens. Instead, the market
19 went from high price peaks of short duration to higher peaks of
20 longer duration.¹³

Cont. _____

¹⁰ *Ibid.*

¹¹ The Value Line Investment Survey, p. 1747 (May 19, 2000).

¹² "Cal-ISO Torn by Politics and Power Industry, Wrestles with Price Caps", *Electric Utility Week* (July 10, 2000).

¹³ "California Energy Crisis: Power Crunch Roils Other Western States – Utilities Seek Higher Rates, Companies Idle Plants; 'It's an Economic Crisis'", *The Wall Street Journal*, p. A2 (January 24, 2001).

1 **Q. Was the AED unique in facing the challenges brought about by these**
2 **unanticipated power market conditions?**

3 A. No. To varying degrees, utilities throughout the Western U.S. have been
4 confronted with the difficult task of maintaining reliable service and financial
5 integrity in a power market characterized by short supply and unprecedented
6 price volatility. Of course, the most notable and well-publicized impact of the
7 regional power crisis has occurred in California. In only a matter of months,
8 inadequate power supplies, rising demand, and the legacy of a failed market
9 structure combined to produce skyrocketing electric prices and rolling blackouts.
10 The massive debts owed by the state's utilities to banks, power producers, and
11 other creditors have shattered their financial integrity and pushed several
12 perilously close or into bankruptcy. For example, in less than a month in early
13 2001, Moody's downgraded PG&E's debt from an investment grade, single-A
14 rating to "Caa2", well below the "B" rating that designates speculative, or "junk"
15 bond status.

16 The regional power crisis has reverberated well beyond California's
17 borders. In Nevada, the build-up in deferred power costs facing Sierra Pacific
18 Resources amounted to hundreds of millions of dollars and prompted the Nevada
19 Legislature to mandate recovery in order to maintain the utility's financial viability.
20 Similarly, IDACORP Inc. reported that low hydroelectric generation and higher
21 purchased power prices resulted in a power cost deferral of \$121 million between
22 April and December of 2000.¹⁴ Meanwhile, Puget Sound Energy noted that
23 purchased electricity expenses had increased \$554.5 million for the nine month
24 period ended September 30, 2000 compared to the same period in 1999.¹⁵ Apart
25 from the AED, the impact of these unprecedented events was also felt in Arizona,
26 as Governor Hull reported to administration officials in Washington. For
27 example, The Wall Street Journal noted that the San Carlos Irrigation District was

¹⁴ *PR Newswire, Inc.*, IDACORP Announces Year-End 2000 Earnings (February 2, 2001).

¹⁵ *Puget Sound Energy*, Form 10Q Report (September 30, 2000).

1 forced to implement rate increases leading to a 300 percent increase in
2 customers' bills and reported that:

3 The Tohono O'odham Utility Authority, which serves the Tohono
4 O'odham Indian Reservation along Arizona's border with Mexico,
5 says it will have to recover an additional \$1 million – on top of a
6 30% rate increase last summer – from its 13,000 customers to
7 cover the California-driven price spikes...¹⁶

8 **Q. Why are dramatic fluctuations in power costs of particular importance for**
9 **regulated utilities?**

10 A. Unlike firms in the competitive market, which are largely free to raise prices and
11 pass higher production costs on to consumers, electric utilities face regulatory
12 limitations on their ability to adjust rates to reflect current market conditions.
13 Even for the majority of electric utilities that have permanent fuel and purchased
14 power adjustment mechanisms in place, there can be a significant lag between
15 the time the utility actually incurs the expenditure and when it is recovered from
16 ratepayers. One example of this regulatory lag was noted by Value Line:

17 **A lag in the recovery of sharply higher power costs is hurting**
18 **Sierra Pacific Resources.** Power prices in the West have soared
19 since the second quarter of 2000, and until recently, SPR's two
20 utilities lacked a mechanism for recovering these increases. The
21 Nevada Commission has granted one, but it won't solve the utilities'
22 problem right away. That's because the mechanism tracks power
23 costs over a trailing 12-month period and because the amount by
24 which the utilities can raise rates each month is capped.¹⁷

25 While having no ability to alter conditions within the wholesale markets for fuel
26 and purchased power, utilities remain obligated to furnish a reliable supply of
27 energy on demand and at fixed rates. The greater business risk implied by this
28 exposure to changes in input prices becomes acute during times of crisis, as is

¹⁶ "California Energy Crisis: Power Crunch Roils Other Western States – Utilities Seek Higher Rates, Companies Idle Plants; 'It's an Economic Crisis'", The Wall Street Journal, p. A2 (January 24, 2001).

¹⁷ The Value Line Investment Survey, p. 1758 (November 17, 2000).

1 evident from recent events in the West. The most extreme example of this
2 exposure is exemplified by Value Line's recent report on PG&E Corporation:

3 **Since mid-2000, PG&E has incurred \$6.6 billion in purchased**
4 **power losses.** Because of the high price its Pacific Gas and
5 Electric subsidiary has been paying for power and its inability to
6 recoup the cost from ratepayers, PG&E and its utility have
7 defaulted on commercial paper maturity payments. This led major
8 rating organizations to lower the company's and its subsidiary's
9 bonds to junk bond status.¹⁸

10 **Q. What impact did these events in the wholesale power markets have on the**
11 **AED's power supply costs?**

12 A. The AED is primarily an electric transmission and distribution utility. Aside from a
13 45 MW combustion turbine located in Nogales, the AED's sole source of power
14 has been provided under an all requirements contract with APS. Beginning in
15 May 2000, the events occurring in Western wholesale energy markets, coupled
16 with APS' interpretation of the Old Contract, led to a dramatic increase in the
17 wholesale price of power to the AED. During the period June through September
18 2000, for example, the average cost of power billed by APS was \$0.127 per
19 kilowatt-hour, or over 2.6 times the \$0.04802 per kilowatt-hour reflected in the
20 generation cost-recovery portion of the AED's basic service rates.

21 As a result of the unprecedented rise in power costs experienced since
22 May 2000, the cumulative under-recovery of power supply expenses represented
23 by the PPFAC bank balance ballooned swiftly. At the end of April 2000, the
24 accumulated balance in the PPFAC bank was \$2.2 million *over-recovered*; but,
25 by the end of May, the unprecedented increase in the AED's cost of wholesale
26 power had shifted this balance to a \$3.6 million under-recovery. At the end of
27 summer 2000, the difference between electricity costs collected in rates and
28 those paid under the Old Contract resulted in an accumulated under-recovery of
29 \$54.3 million. In the span of just five months, the AED had been forced to cover
30 a shortfall in power costs almost equal to its total purchased power and

1 transmission expenses for the prior year. The prolonged volatility in wholesale
2 electric markets experienced during the second half of 2000 and into 2001 only
3 served to further exacerbate this disparity. Unable to dissuade APS from its
4 interpretation of the terms of the Old Contract, the AED's under-collections
5 continued to mount swiftly and dramatically. By May 2001, a year after the crisis
6 began, the AED had paid a total of almost \$84.7 million more for wholesale
7 power than the charges it had collected from its customers.

8 **Q. What implications did these unrecovered power costs have for the AED's**
9 **financial viability?**

10 A. For a small, regional utility such as the AED, the magnitude of these under-
11 collections was staggering. As noted above, in meeting its obligations to ensure
12 continuous service for customers, in a single summer the AED incurred
13 unrecovered supply costs equivalent to an entire years' bill for purchased power.
14 In assessing the financial implications of these power cost deferrals, it is
15 important to recognize that Staff and the Commission have historically viewed
16 the AED as a low risk, stand-alone utility. This treatment was exemplified by the
17 ACC's treatment of income taxes in its Decision No. 59951 in the AED's 1995
18 rate proceeding:

19 Both RUCO and Staff applied a 34 percent rate with the rationale
20 that on a stand-alone basis, the Company would have less than
21 \$10 million in income... On a stand-alone basis, the Company
22 would fall into the 34 percent federal tax bracket and that is the rate
23 recommended by Staff and RUCO... We find Staff and RUCO's
24 recommendations to utilize a 34 percent rate to be reasonable
25 under the circumstances.¹⁹

Cont. _____

¹⁸ The Value Line Investment Survey, p. 1757 (February 16, 2001).

¹⁹ ACC Decision No. 59951 at 21.

1 Similarly, the Staff rate of return witness cited the relatively low risks of the AED,
2 including the approved PPFAC, in justifying her decision to recommend a rate of
3 return on equity below the midpoint of her range.²⁰

4 As shown in the table below, based on comparative data obtained from
5 the ACC's Decision No. 59951 in the AED's 1995 rate proceeding, on a stand-
6 alone basis the PPFAC bank balance quickly became extreme by any
7 measure²¹:

| PPFAC Balance | Rate Base | Common Equity | Revenue Requirements |
|--------------------------|------------------|--------------------------|---------------------------------|
| Sep-00 | 0.60X | 1.18X | 0.67X |
| May-01 | 0.94X | 1.84X | 1.05X |

8 By September 2000, when the AED filed its first application to change its PPFAC,
9 the amount of unrecovered power costs paid by the AED to APS under the Old
10 Contract exceeded the total common equity investment established by the ACC
11 for the AED's system and amounted to two-thirds of annual revenue
12 requirements. By the end of May 2001, when the AED completed negotiation of
13 the New Contract, the balance of deferred power costs accumulated in the
14 PPFAC bank was almost as large as the total original cost rate base approved by
15 the ACC in Docket No. E-1032-95-433 and amounted to more than a full year's
16 revenue requirements for the system.

17 As the above comparison illustrates, when viewed in a manner consistent
18 with the stand-alone treatment afforded the AED in its last rate proceeding, the
19 unrecovered power costs accumulated in the PPFAC bank imposed a severe
20 financial burden. Absent continued support from the AED's parent, Citizens
21 Communications, the enormous cash drain associated with the AED's inability to

²⁰ Docket No. E-1032-95-040, Testimony of Linda A. Jaress at p. 21.

²¹ Data from the ACC's Decision in Docket No. E-1032-95-040 was used to provide an objective basis for comparison. Updating the results to reflect current results would not change the conclusions of the analysis.

1 recover its cost of power would have almost certainly resulted in bankruptcy, with
2 all the attendant implications for service reliability.

3 **Q. How did the AED respond to these unprecedented events?**

4 A. Considering the financial hardship posed by its inability to recover its power costs
5 from customers, the AED was confronted with a crisis of extreme proportions. As
6 discussed in the testimony of the AED's witnesses, the utility informally
7 communicated with Staff and then formally notified the Commission of its plight in
8 filing this Application, initiated an audit of APS' charges under the Old Contract,
9 and strenuously pursued further negotiations with APS while evaluating
10 alternative methods of resolving the conflict. In the meantime, the AED
11 continued to meet its obligation to customers by absorbing the enormous cash
12 drain created by the widening gap between its cost of wholesale power and its
13 existing rates. Ultimately, the AED concluded that negotiation of a new
14 agreement provided the best opportunity to provide a guaranteed supply of
15 power, insulate customers from further price volatility, and stave off financial
16 disaster.

17 **Q. Is it reasonable to assert that the AED should have anticipated the**
18 **dislocations in wholesale power markets that began in the summer of**
19 **2000?**

20 A. No. As noted above, the unprecedented and prolonged spike in wholesale
21 electricity prices in the West was beyond the contemplation of all market
22 participants. The AED reasonably believed that its customers were protected
23 from price volatility under the terms of its agreement with APS. But even large
24 utilities with highly sophisticated trading operations that were cognizant of their
25 exposure to changes in wholesale power prices were blindsided by the
26 protracted crisis that began in May of 2000. With the benefit of perfect hindsight,
27 it is not especially difficult for Ms. Smith to speculate on what the AED might
28 have done in the early months of 2000 to protect itself from the coming debacle.
29 If the rapid run-up in power prices that occurred subsequently had been as
30 evident as Ms. Smith alleges, great fortunes could have been won with little or no

1 risk. Of course, this ignores the realities of what actually took place and attempts
2 to ascribe a degree of foresight far beyond what can reasonably be expected of
3 prudent management or what is required under accepted regulatory standards.

D. Prevailing Regulatory Policy and Circumstances

4 **Q. What is the purpose of this section of your testimony?**

5 A. Both Ms. Smith and Dr. Rosen are critical of the AED's Old Contract with APS
6 and how it was administered. This section examines the regulatory history of the
7 Old Contract and shows that the AED's actions were reasonable under the
8 circumstances and consistent with regulatory policy.

9 **Q. When was the Old Contract first examined by this Commission?**

10 A. In its last rate case (Docket No. E-1032-95-433), the AED requested that the
11 PPFAC be suspended in the belief that its contract with APS would prevent
12 future volatility in purchased power costs. In that case, Mr. Ralph C. Smith
13 presented testimony on behalf of the Staff recommending continuation of the
14 PPFAC because customers could be expected to benefit from future decreases
15 in purchased power costs.²² Similarly, Dr. Steven Anderson, testifying on behalf
16 of RUCO, recommended keeping the PPFAC in place.²³ Dr. Anderson testified
17 that based on his analysis of the contract, prices could be expected to decline
18 and the AED would over-recover its purchased power costs if the PPFAC were
19 eliminated. The ACC agreed with these recommendations in its January 3, 1997
20 Opinion and Order:

21 We agree with Staff and RUCO that the PPFAC should be retained.
22 Citizen's power is primarily purchased, and therefore, changes in
23 power purchase mix, as well as cost changes, could have a
24 significant impact. The purpose of the fuel adjustor is to respond to
25 cost/price changes, decreases as well as increases. To suspend
26 the clause when costs are decreasing, and only allow it to remain in
27 effect when prices are increasing, would defeat the purpose of this

²² Testimony of Ralph C. Smith, Docket No. E-1032-95-433 at p. 127.

²³ Testimony of Steven Anderson, Docket No. E-1032-95-433 at p. 2.

1 clause, and would result in an over-recovery of purchased power
2 expense. We are approving the Company's request for pricing
3 flexibility, and believe that it can address its concerns about
4 competition through the use of that tariff. We also agree with Staff's
5 recommendation that as of the effective date of this Decision, any
6 PPFAC bank balance should be refunded to customers (if over-
7 collected) or added to customers bill as a surcharge (if under-
8 collected).²⁴

9 **Q. Do you agree with Ms. Smith and Dr. Rosen that the AED did not respond**
10 **properly when differences arose with APS in the interpretation of the Old**
11 **Contract?**

12 A. No. The AED began negotiating with APS when differences in interpretation first
13 arose in 1999. By May of 2000, the AED thought it had reached an agreement
14 with APS that would insulate its customers from wholesale price volatility. Given
15 that the AED was dependent on and contractually bound for many years to APS
16 for virtually all of its power under a contract approved by FERC, the first logical
17 step in dispute resolution was to negotiate. As Mr. Breen discusses in his
18 testimony, the Memorandum of Understanding (MOU) signed with APS on May
19 18, 2001 indicated that the AED's strategy seemed to have worked.²⁵

20 The understanding that the AED thought had been reached with APS did
21 not withstand the cataclysmic events of summer 2000, when the California
22 debacle spilled over to APS, along with other utilities in the Western Systems
23 Coordinating Council (WSCC). Once the AED realized that APS did not intend to
24 abide by the understanding outlined in the MOU, it engaged consultants and
25 attorneys to review its options and audit the accuracy of billings from APS. The
26 AED also informally discussed the situation with ACC staff and RUCO, and on
27 September 28, 2000, the AED formerly alerted the Commission of its
28 predicament and initiated this case.

²⁴ Decision No. 59951, Docket No. E-1032-95-433 at p. 40.

²⁵ At p. 15 of her testimony, Ms. Smith grants that APS made changes to its billing methodology as a result of the AED's negotiations.

1 **Q. Ms. Smith and Dr. Rosen claim that the AED could have done more to**
2 **mitigate the high bills from APS during the summer of 2000. Is it**
3 **reasonable to believe that the AED would not vigorously pursue lower**
4 **purchased power costs?**

5 A. No. Purchased power was the AED's major cash expense. By the time of its
6 September 28, 2000 filing the balance in the PPFAC bank had risen to in excess
7 of \$54 million. This represented approximately 110 percent of the common
8 equity that the ACC found reasonable for the AED system in its 1997 Decision.
9 Not earning a return on this investment would reduce the AED's return on equity
10 to less than 2.5 percent.

11 It is inconceivable to me that a company facing this magnitude of a cash
12 drain, and the accompanying impact on its financial results, would not take every
13 action it thinks would be effective to mitigate such a crisis. My review of the
14 documents and discovery in this case as well as my discussions with the AED's
15 executives confirms that they were pursuing the most effective and timely course
16 of action to reduce the material financial burden given the information available at
17 the time. Ms. Smith's suggestion that the AED should have pursued "a more
18 intensive renegotiation strategy"²⁶ does not square with the financial challenge
19 the AED was facing or its extensive effort to resolve the crisis, as discussed in
20 greater detail by Mr. Breen. Similarly, Dr. Rosen makes the revealing
21 observation:

22 One cannot be certain that Citizens and APS would have
23 consummated a mutually satisfactory contract along the foregoing
24 lines. On the other hand, however, one can be confident that the
25 chances of success would have been improved had there been a
26 more timely and more extensive effort to do so.²⁷

27 I find it telling that Staff and RUCO witnesses both believe that if somehow the
28 AED had negotiated harder APS would have changed its position. As a result of
29 this speculation, these witnesses propose regulatory disallowances that would

²⁶ Testimony of Ms. Lee Smith at p. 6.

²⁷ Testimony of Dr. Richard A. Rosen at p. 31.

1 destroy the financial integrity of the AED. Yet neither witness can say that had
2 the AED negotiated "more strenuously" the outcome would have been different.
3 Moreover, the AED had enormous financial incentive to negotiate as effectively
4 as possible.²⁸ As demonstrated by the AED's other witnesses, their testimony
5 also effectively ignores the range of efforts the AED pursued.

6 **Q. Are there established regulatory policies related to the AED's application to**
7 **recover the accumulated PPFAC bank balance?**

8 A. Yes. A fundamental tenet of the regulatory compact is that the utility is entitled to
9 an opportunity to recover from consumers all reasonable and necessary costs
10 incurred in providing service, including a fair return on investment, and that these
11 costs should be born by those for whose benefit they were incurred. In
12 exchange, the utility agrees to provide safe, reliable service to customers at a
13 reasonable cost.

14 **Q. Is the recovery of the AED's unrecovered power costs through an**
15 **amortization of the PPFAC bank balance consistent with regulatory policy?**

16 A. Absolutely. The inclusion of all reasonable and necessary costs in rates is the
17 essence of public utility regulation. Not only is this obligation related to the
18 control of natural monopolies, but it is also essential to encourage efficient utility
19 operations and assure reliable utility service to consumers. Apart from
20 maintaining adequate utility service, the opportunity to recover reasonable and
21 necessary expenditures, including fuel and purchased power costs, is central to
22 the cost-of-service approach to regulation adopted in Arizona and elsewhere in
23 this country. My review of past orders reveals that the ACC has a long history of
24 establishing fuel and purchased power recovery mechanisms.

²⁸ Later in my testimony I demonstrate that none of the specific actions that Ms. Smith and Dr. Rosen suggest the AED could have taken could have reasonably been expected to mitigate the escalation of unrecovered purchased power costs.

1 **Q. What makes the current situation particularly challenging to the AED?**

2 A. A short-term aberration in wholesale market prices would not have led the
3 PPFAC bank balance to increase beyond all reasonable expectations. Indeed,
4 utilities understand that occasionally there will be a lag in recovering a portion of
5 actual power costs if prices deviate from predictions on the high side. Similarly,
6 customers also recognize that AED might collect more than its actual costs when
7 prices break their way. However, the sums involved in such cases are usually
8 relatively small compared to the size of the utility.²⁹ But the extreme and
9 persistent volatility in purchased power costs that began in the second quarter of
10 2000 was highly abnormal and unprecedented. Notwithstanding the AED's best
11 efforts to moderate the impact of these extraordinary risks, in the year
12 subsequent to the signing of the New Contract the Company incurred some \$87
13 million in power costs over and above those included in present rates in order to
14 meet its service obligations to Arizona customers. Requiring the AED's
15 shareholders to absorb these reasonable and necessary expenses would be
16 confiscatory and impose an extreme financial burden on the utility.

17 **Q. Are the extraordinary power costs at issue in this proceeding analogous to**
18 **other expenses that might be deferred and recovered through future rates?**

19 A. Yes. Perhaps the most directly comparable example would be the regulatory
20 treatment typically afforded to uninsured costs incurred due to severe storms or
21 other catastrophic events. Since both the timing and the magnitude of such
22 costs are unknown, the unanticipated and extraordinary expenses of storms are
23 capitalized after-the-fact and recovered through future rates. In fact, recent
24 circumstances in the Western power markets share many of the characteristics
25 that distinguish other catastrophic events, such as natural disasters. First, the
26 events precipitating the power market crisis were unexpected by market
27 participants, and there was no basis in past experience that would have allowed

²⁹ Indeed, under the PPFAC mechanism, when the absolute value of the bank balance reaches \$2.6 million, the AED is required to file for a rate adjustment or initiate discussions with Staff.

1 the extent of the market dislocation to be anticipated. The unexpected and
2 disaster-like conditions sparked by capacity shortages, extreme weather, and the
3 crisis in California have been widely reported. As noted by Fortune magazine:³⁰

4 When it comes to big-time economic disasters, it can be hard to
5 specify exactly when “the situation” turned into “the crisis” and “the
6 crisis” turned into “the catastrophe.” Nonetheless, there always
7 comes a moment when everyone knows that the point of
8 catastrophe has not only been reached but passed.

9 As with the aftermath of a major storm or natural disaster, the AED has been
10 forced to bear significant costs in meeting its commitment to provide reliable
11 service that have not been considered in existing rates. Moreover, just as the
12 utility has no control over acts of nature, the AED has no ability to control or
13 influence the events that have conspired to inflate regional energy prices.

14 Denying the AED the ability to recover abnormal costs, such as those
15 related to extreme purchased power expenses, would imply a dramatic increase
16 in investment risk and required rate of return. Investors’ required rates of return
17 for utilities are premised on the regulatory compact that allows the utility an
18 opportunity to recover reasonable and necessary costs. And by sheltering
19 utilities from exposure to extraordinary or catastrophic events that are beyond the
20 control of management, ratepayers benefit from lower capital costs than they
21 would otherwise bear. Of course, the corollary implies that shifting the burden of
22 extraordinary risks to shareholders would have the effect of considerably
23 increasing the cost of equity to the AED and other utilities operating in Arizona,
24 with the end-result being a substantially greater cost of utility service throughout
25 the state.

³⁰ *Fortune*, “Who Turned The Lights Out?”, p. 111 (February 5, 2001).

E. Mitigation

1 **Q. What is the purpose of this section of your testimony?**

2 A. Ms. Smith and Dr. Rosen suggest that the AED should have taken a number of
3 actions to mitigate the rising purchased power cost under the Old Contract. This
4 section explains why none of these actions could reasonably have been
5 expected to impact the build-up of deferred power costs in the PPFAC bank.

6 **Q. Would the hedge proposed by Ms. Smith have been a reasonable way to
7 mitigate the buildup in the PPFAC bank?**

8 A. No. First, as Ms. Smith recognizes, requesting APS to initiate a hedge would
9 have undermined the AED's position in its negotiations:

10 I recognize that, if Citizens were to continue negotiations with APS,
11 requesting APS to purchase a physical hedge on its behalf for
12 summer 2000 might have been problematical.³¹

13 Ms. Smith recognizes that the AED believed it would have been necessary to
14 obtain ACC approval before moving forward with a hedging strategy, but stated
15 her opinion that such approval would not be necessary. In any event, Ms. Smith
16 concluded, the AED should have requested permission long before September
17 28, 2000.³²

18 Ignoring the fact that the wholesale market crisis experienced in the
19 summer of 2000 was unforeseen, if the AED had requested permission to initiate
20 a hedge in the spring of 2000, its position in negotiations and potential litigation
21 would have been, to use Ms. Smith's term, "problematic". Indeed, Ms. Smith
22 recognizes that a hedge could have "jeopardized the negotiations"³³. The AED
23 did not have the benefit of Ms. Smith's opinion that no Commission approval
24 would be necessary to initiate a hedge. Had the AED made application to the

³¹ Testimony of Ms. Lee Smith at p. 7.

³² *Ibid.* at p. 8

³³ *Ibid.* Since the AED was obliged to purchase all of its electricity through the Old Contract, APS would have had to participate in any hedging transaction.

1 Commission, it would have signaled weakness to APS that would have been
2 detrimental in its negotiating efforts to resolve the situation. Moreover, it is
3 unclear how much time would have been required to obtain the Commission's
4 approval and whether Staff and RUCO would have endorsed such actions at the
5 time. This uncertainty is highlighted by the Staff's October 1998 Report on
6 Purchased Gas Adjustor Mechanisms:

7 One approach used by various businesses to address price
8 volatility is to employ financial instruments such as futures...
9 Currently, Arizona LDCs do not use financial instruments. Use of
10 financial instruments can be a complex process and may expose
11 the LDC to risks it would not otherwise face. Nationally, there have
12 been a number of cases where large corporations have lost
13 significant amounts of money using financial instruments in recent
14 years. If Arizona LDCs are to begin using financial instruments, the
15 ramifications of such use should be carefully considered. If an
16 Arizona LDC wishes to use financial instruments, the Commission
17 should consider such requests, but should carefully study the
18 potential impacts on the LDC and Arizona natural gas customers.³⁴

19 In his testimony, Mr. Dabelstein notes that the Commission still has done nothing
20 concerning recommendations regarding hedging activities resulting from the
21 1998 purchased gas adjuster docket (Docket No. G-00000C-98-0568).

22 Economists know that hedges, like lunches, are not free. If Ms. Smith is
23 correct that it was clear to market participants that higher wholesale power prices
24 were coming in the summer of 2000, then any rational counterparty would have
25 demanded a very high price to bear the risk of delivery at a fixed price. Ms.
26 Smith's suppositions regarding expectations for higher wholesale power prices
27 and the AED's ability to hedge are essentially analogous to suggesting that
28 purchasing homeowners insurance after your house is on fire would be an
29 economically feasible transaction.

³⁴ Docket No. G-00000C-98-0568, Staff Report on Purchased Gas Adjustor Mechanisms
(October 19, 1998).

1 **Q. Is Ms. Smith correct at p. 7 that the AED should have sought guidance from**
2 **the ACC or requested that FERC assist in the dispute with APS?**

3 A. No. Just as opening the hedging issue would have jeopardized negotiations, so
4 would filing formal action with a regulatory commission or court. If the parties to
5 a negotiation realize the issue is being litigated in the regulatory arena or in the
6 courts, the process of reaching a favorable settlement changes fundamentally.
7 No longer are the parties just evaluating each other's positions; they must also
8 consider their posture for other forums. Mr. Flynn addresses the legal aspects of
9 litigation, but from a financial standpoint the key issue is time. Up through May
10 2000 the AED thought it had successfully resolved outstanding issues with APS
11 concerning the Old Contract. But once the dramatic increases in power bills
12 began and APS reversed field, the AED quickly realized the need to seek as
13 expedient a resolution as possible. The most likely route to a quick and
14 successful resolution of such a dispute was through face-to-face negotiation, not
15 the protracted and adversarial forum of regulatory or civil litigation.

16 Dr. Rosen suggests:

17 If Citizen's had filed a complaint with FERC regarding the
18 magnitude of its bills from APS on or about January 1, 2001, that
19 complaint would likely have been resolved well before now.³⁵

20 I have been involved with cases before FERC and its predecessor agency for
21 almost 25 years. No one can predict how long it would take to resolve a
22 particular litigated case. Since January 2001, the pace of any specific
23 proceeding is even more unclear given the turmoil at that agency associated with
24 a change in leadership, high-profile issues such as the California debacle and the
25 collapse of Enron, and the myriad issues surrounding initiatives to create and
26 approve regional transmission organizations. Standard & Poor's Corporation
27 (S&P) very recently noted the dramatic increase in the regulatory burden at
28 FERC:

³⁵ Testimony of Richard A. Rosen at p. 14.

1 Despite the relatively low inflation experienced in the 1990s, the
2 rulemaking inflation at the FERC has apparently increased one
3 thousand fold since 1995, when the commission introduced the
4 electric industry-changing MegaNOPR (Notice of Proposed
5 Rulemaking).

6 The electric industry now faces the imminent release of a new
7 proposed rulemaking that is so massive it is being dubbed the
8 GigaNOPR. The ancient Romans called the middle of the month
9 the "ides," hence the astrologers warning to Julius Caesar in
10 Shakespeare's play to "beware the ides of March." The FERC will
11 meet on March 13 this year (the ides fell on either the 13th or the
12 15th), and it may be prudent for the electric utility industry to
13 likewise beware, if as expected, the FERC issues the GigaNOPR
14 next month.³⁶

15 Neither Dr. Rosen nor anyone else could have given any concrete assurance to
16 the AED that a quick resolution of its dispute with APS was available through a
17 FERC proceeding.

18 **Q. Would there have been any downside to the AED associated with initiating**
19 **litigation?**

20 A. Yes. Both Ms. Smith (p. 35) and Dr. Rosen (pp. 9-10) note that an order
21 favorable to the AED would have strengthened its position in negotiations with
22 APS. By the same token, an adverse ruling would have undermined the AED's
23 negotiating position. The bottom line is that the AED did not have the luxury of
24 armchair speculation on the potential outcome of litigation. The AED's primary
25 concern was to maintain reliable service to customers while choosing the best
26 course to resolve its differences with APS and assure continued availability of
27 power at a reasonable price. While Ms. Smith and Dr. Rosen can speculate that
28 litigation may have been a better course, it was not obvious at the time or even in
29 hindsight. The AED had everything to lose and nothing to gain by choosing
30 poorly.

³⁶ Standard & Poor's, "U.S. Regulators to Reshape Electric Industry With New Rulemaking",
RatingsDirect, p. 1 (February 15, 2002).

1 **Q. Dr. Rosen suggests that the AED should have petitioned FERC to establish**
2 **price caps in Western markets (pp. 7-8). Would this have been likely to**
3 **change the course of events at FERC?**

4 A. No. As I noted earlier, the calamity in Western power markets was front-page
5 news across the nation. Political leaders, Nobel economists and a host of other
6 voices were being raised for FERC action. There is no reason to believe that
7 adding the AED to the chorus would have accelerated or affected FERC action.

8 Dr. Rosen similarly suggests that the AED should have requested that this
9 Commission review APS' past generation supply and future plans (p.8)³⁷. The
10 presumption of this suggestion is that the ACC was unaware of the
11 circumstances confronting APS and that a wake-up call from the AED would
12 have made all the difference. But as Dr. Rosen granted, the prudence of APS'
13 supply planning was the responsibility of the Commission, not the AED:

14 The issue of supply planning for APS is, in my opinion, primarily a
15 regulatory issue for the ACC... [T]he task of determining whether
16 APS was prudent in its supply planning in order to provide for both
17 its firm wholesale and retail loads falls primarily to the ACC.³⁸

18 Again, the Staff and RUCO also could have raised these issues to this
19 Commission since all parties were aware of the dispute between the AED and
20 APS after the September 28, 2000 filing in this case.

21 **Q. What is your conclusion regarding the steps that Ms. Smith and Dr. Rosen**
22 **fault the AED for failing to pursue?**

23 A. The actions that Ms. Smith and Dr. Rosen have suggested in hindsight would
24 have been inconsistent with the AED's efforts to successfully resolve its dispute
25 with APS, ignore attendant uncertainties and costs, and were unlikely to have a
26 significant impact on the PPFAC bank balance in time to avert financial disaster.
27 Hedging instruments can involve significant costs and risks in their own right, and
28 there was no established Commission policy supporting such action. Moreover,

³⁷ Mr. Dabelstein discusses the jurisdictional problems associated with this suggestion.

³⁸ Testimony of Richard A. Rosen at p. 12

1 a request by the AED to initiate a hedging program or the filing of a formal action
2 at a regulatory agency or court could have compromised the AED's position in
3 negotiations with APS and were unlikely to result in a swift resolution to the
4 dispute or a timely reduction in purchased power costs. Given the serious
5 implications that expectations for continued price volatility posed for both
6 customers and the financial viability of the AED, the Company's strategy of
7 negotiation offered the most reasonable path out of the morass, especially in light
8 of the realities at the time.

F. New Contract

9 **Q. What is the reasoning behind Dr. Rosen's conclusion that rates under the**
10 **New Contract are "too expensive"?**

11 A. Dr. Rosen bases his conclusion on two principal arguments:

- 12 1. The fact that the New Contract was signed in July 2001 indicates that it
13 is not just and reasonable; and,
- 14 2. Rates under the New Contract are higher than what the AED paid
15 historically under the Old Contract or those proposed by APS for
16 standard offer customers.

17 **Q. Please address Dr. Rosen's contention that the timing of the New Contract**
18 **is "highly relevant" to a determination of its reasonableness.**

19 A. I agree completely with Dr. Rosen. The fact is, the agreement that the AED
20 reached with APS in May 2001 reflected the persistent uncertainties over the
21 future course of wholesale power market prices and the AED's best efforts to
22 insulate customers from ongoing risks. An evaluation of the New Contract that
23 ignores these realities, or one that is based on the benefits of perfect hindsight,
24 would simply be unreasonable.

1 **Q. Was the moderation in wholesale electric markets that occurred**
2 **subsequent to negotiation of the New Contract anticipated by market**
3 **participants?**

4 A. No. The volatility and uncertainties that had characterized the Western power
5 markets during the summer of 2000 persisted throughout the entire period during
6 which the AED was negotiating the New Contract. Now that the magnitude of the
7 crisis in the West had become clear and apparent to all parties, there was
8 considerable concern among market participants that conditions during the
9 summer of 2001 would match those of the preceding year. RUCO recognized
10 Arizona's continued exposure to the fallout from events in California:

11 How long the situation will continue, and to what degree the federal
12 government will attempt to control wholesale prices and shore up
13 supplies where there are shortages, remains unknown. The
14 Residential Utility Consumer Office in Arizona, along with its
15 counterparts in other Southwestern states, are scrambling to
16 prevent California from "stealing" other states' power at cut-rate
17 prices. RUCO Director Lindy Funkhouser said Citizens' filing with
18 the Arizona commission "makes it clear they're vulnerable to the
19 California crisis." His concern is that ratepayers across the
20 Southwest will eventually suffer because of California's failure to
21 generate enough power of its own.³⁹

22 These concerns were voiced at the highest levels of government, with Arizona's
23 Governor declaring in her State of the State speech on January 8, 2001 that:

24 I continue to monitor the electricity problem in California and, make
25 no mistake, I will take whatever action is necessary to protect
26 Arizonans and Arizona power.⁴⁰

27 Indeed, taking action to protect consumers while putting a tourniquet on its
28 severe cash flow drain were also the primary motivations behind the AED's
29 negotiations with APS.

³⁹ Brady, Ann, "Some Southwest Power Cos. Hurt By Crisis, Others Prosper", Dow Jones News Service (January 16, 2001).

⁴⁰ Governor Jane Dee Hull, State of the State, 45th Arizona Legislature, First Regular Session (January 8, 2001).

1 Concerns regarding the potential for extreme prices and power shortages
2 continued unabated during the months leading up to the conclusion of the AED's
3 negotiations with APS in May 2001. The Associated Press reported in April 2001
4 that "people almost certainly will pay more for energy this summer" and the
5 Chairman of PG&E stated that there could be another "meltdown in the Western
6 power market".⁴¹ Similarly, an April 27, 2001 Los Angeles Times article noted
7 that:

8 The federal order aimed at stabilizing wholesale power costs in
9 California is so flawed that prices will continue soaring, putting even
10 greater pressure on state coffers and consumer bills, government
11 officials and energy experts said Thursday. ...Evidence of the
12 market's seemingly unending volatility can be found every day. On
13 Wednesday, the state paid \$90.3 million to buy electricity for
14 customers of Edison, PG&E, SDG&E – roughly double the daily
15 costs of a month ago.⁴²

16 The bleak outlook for Western power markets was recognized by the North
17 American Electric Reliability Council, as reported in the May 21, 2001 edition of
18 *Electric Utility Week*:

19 With at least 260 hours worth of rotating blackouts projected for
20 California, the second-lowest hydro supply year in the Northwest
21 ever, and an extremely tight supply picture for New York City, this
22 summer could be the worst one yet for electric system reliability,
23 the North American Electric Reliability Council said last week.

24 "That's an unqualified 'Yes'," said NERC President and CEO
25 Michehl Gent when asked if that description would fit... The state
26 [California] could see up to 700 hours of blackouts if interruptible
27 customer relief is not available, if customers do not respond to rate
28 hikes and if conservation does not accomplish as much demand
29 reduction as hoped for, according to NERC.⁴³

⁴¹ Hebert, Josef H., "Power Crunch: California outages stir fears across nation", Associated Press (April 9, 2001).

⁴² Vogel, Nancy, "Federal Caps Will Let Electric Costs Soar", Los Angeles Times, p. A-1 (April 27, 2001).

⁴³ "NERC Fears Worst Summer Yet in West, Worries About Congestion in the East", *Electric Utility Week*, p. 10 (May 21, 2001).

1 ICF Consulting Group, Inc., a source referenced by Ms. Smith (p. 27) as having
2 correctly anticipated the price increases in the summer of 2000, noted in an April
3 4, 2001 News Release that:

4 California, other western states, and some other markets face
5 potentially serious shortages this summer. "California faces
6 potentially severe problems this summer," says Judith Rose,
7 managing director of ICF Consulting's wholesale power practice.⁴⁴

8 Regarding the outlook for Western power markets, FERC Commissioner William
9 Massey noted that he feared "for the worst" and stated that shortages and "out-
10 of-control prices" were likely.⁴⁵

11 Indeed Dr. Rosen granted that there was no way the AED could have
12 foreseen when its power bills would moderate or wholesale prices would ease.⁴⁶

13 Similarly, Dr. Rosen also recognized that it was not clear that wholesale power
14 prices would moderate at the time the AED entered into the New Contract.⁴⁷

15 Considering the significant uncertainties over wholesale markets and widespread
16 belief that price volatility could mirror the summer of 2000, the AED's decision to
17 pursue negotiation of a new contract that would insulate customers and the utility
18 from the vagaries of price fluctuations was a very reasonable course of action.

19 **Q. Was it clear in the spring of 2001 that FERC would step in to quell the crisis**
20 **in Western power markets by extending price caps throughout the West?**

21 A. No. While the idea of extending control over Western power markets was
22 certainly broached by the time the AED completed its negotiations with APS,
23 there was no indication that such actions were favored by FERC or the form they
24 might eventually take. Not until April 26, 2001 did the FERC initiate a formal
25 investigation into irregularities in the Western interconnection and seek
26 comments on what measures it might take to control prices. While the FERC

⁴⁴ ICF Consulting Group, Inc., *Press Room News Release* (April 4, 2001).

⁴⁵ "House Panel May Act on Bill to Help Calif., But its Future Still Looks Dim", *Electric Utility Week*, pp. 4-5 (May 7, 2001).

⁴⁶ Testimony of Richard A. Rosen at pp. 10-11.

⁴⁷ *Ibid.* at p. 27.

1 initially described plans to extend the methods adopted for California throughout
2 the WSCC, there was considerable debate regarding the practicality, legality, and
3 effectiveness of this proposal. As a contemporaneous report summed up:

4 **But according to nearly all stakeholders**, while FERC's attempts
5 to take control of the Western market are well-intentioned, they
6 simply do not work.⁴⁸

7 In a similar vein, Value Line reported to investors in early June 2001 that:

8 To California Governor Gray Davis' disappointment, the
9 administration has not laid down any short-term solutions and has
10 rejected (as has the FERC) the implementation of temporary
11 wholesale price caps. The state is under tremendous pressure with
12 demand soaring and new supply slowly coming on line. It is
13 attempting to force the FERC, via the federal courts, to implement
14 the price measures. At this juncture, the outlook for this initiative
15 does not appear good.⁴⁹

16 Given the lack of clarity regarding the potential for FERC intervention in Western
17 power markets, the fact that price caps were subsequently implemented provides
18 no basis to evaluate the prudence of the AED's actions or the reasonableness of
19 the New Contract.⁵⁰

20 **Q. Does Dr. Rosen provide any support for his belief that a repeat of recent**
21 **volatility in wholesale power prices is unlikely over the term of the new**
22 **contract?**

23 A. No. The only support Dr. Rosen offers for this belief is his observation that the
24 FERC is taking this issue "far more seriously" than it did prior to June 2001.
25 While this may assure Dr. Rosen, it certainly provides cold comfort to customers
26 and utilities that have dealt first-hand with the recent vagaries of increasingly
27 competitive wholesale power markets. Competition provides an efficient forum

⁴⁸ "FERC Hears No Encouraging Words on Price-Mitigation Idea for West", *Electric Utility Week*, p. 5 (May 14, 2001).

⁴⁹ The Value Line Investment Survey, p. 159 (June 8, 2001).

⁵⁰ *Inside FERC* (February 4, 2002) noted that the price cap in effect from June 21 through December 19, 2001 was \$92/Megawatt-hour.

1 for buyers and sellers to reflect their expectations into current prices, but the
2 transition to competitive markets envisioned by the FERC also implies the
3 potential for increased price volatility as participants react to new information. In
4 addition, as markets transition to greater competition it becomes increasingly
5 difficult for regulators, such as FERC, to exert control over the outcome. This
6 has been amply demonstrated since the summer of 2000, as federal and state
7 regulators and politicians have struggled to find an effective, workable means to
8 reign in wholesale power prices. Contrary to Dr. Rosen's belief, FERC action is
9 not always a panacea, as *Electric Utility Week* reported:

10 The Federal Energy Regulatory Commission last week gave
11 transmission owners financial incentives that it hopes will prompt
12 rapid improvement and investment in transmission facilities
13 throughout the Western Systems Coordinating Council. But
14 industry sources are skeptical about just how quickly new projects
15 can come on-line, given lengthy permitting and construction
16 processes the federal government has no authority over. ...

17 At the same time, FERC itself wonders in the order just how
18 much impact its previous decisions have had in curbing runaway
19 wholesale prices in California. In a footnoted entry, the commission
20 insinuates that its Dec. 15, 2000, order that set forth numerous
21 changes to California's wholesale markets – including an
22 elimination of the buy/sell requirement through the California Power
23 Exchange and an insistence on long-term contracts – may not be
24 helping at all.⁵¹

25 Dr. Rosen's unsupported opinions regarding the future course of wholesale
26 power prices is no substitute for prudent planning, as APS stated succinctly in its
27 October 2001 request for a variance from Rule 1606:

28 In recent months, wholesale power costs have softened and some
29 have even talked about a future "glut" of power. APS is mindful
30 that this recent downturn in prices was no more foreseen by these
31 "experts" than was the explosion in prices a year earlier. Wishful
32 thinking does not take the place of prudent planning, and even the
33 recent unexpected drop in wholesale power and natural gas prices

⁵¹ "FERC Sweetens the Pot for Investment in New Lines in WSCC; Impact Unclear", *Electric Utility Week*, p. 11 (May 21, 2001).

1 is proof that electric markets continue to be very volatile and
2 susceptible to wild and irrational price swings.⁵²

3 **Q. Do the rates historically paid by the AED or those proposed by APS for**
4 **standard offer customers provide a valid basis to evaluate the**
5 **reasonableness of the New Contract?**

6 A. No. As demonstrated above, the New Contract that the AED successfully
7 negotiated to prepare for the summer of 2001 reflected the realities of the power
8 markets and the considerable uncertainties facing utilities and their customers at
9 the time. Given that these dislocations were not even contemplated at the time
10 the Old Contract was entered into, the outcome of Dr. Rosen's price comparisons
11 with the New Contract are not very surprising, nor are they illuminating.

12 If the turmoil in the electricity markets over the past two years has taught
13 us anything, it is that the past is not a prologue to the future. The fact that the
14 New Contract provides for higher prices than the past is neither necessary nor
15 sufficient to establish that its price is unreasonable. First, the AED had an
16 existing contract with APS that had been approved by FERC and reviewed by the
17 ACC. It was not free to shop for a new power supplier, nor would it necessarily
18 have been prudent to do so in the face of the looming uncertainties that
19 characterized the power markets during the spring of 2001. Many sophisticated
20 participants in the power markets, including the State of California, locked
21 themselves into long-term contracts in what was perceived to be a sellers' market
22 for electric capacity. For example, after reporting in January 2001 that the
23 California Power Exchange recommended that utilities reduce their exposure to
24 spot prices by signing two to five year contracts at a price of \$74 per megawatt-
25 hour. While this price is \$0.0152 per kilowatt-hour higher than the \$0.0588 per
26 kilowatt-hour under the New Contract, Value Line noted that "agreements at that
27 price might be difficult to achieve".⁵³ Other utilities, such as Sierra Pacific

⁵² Docket No. E-01345A-01-____, Request of Arizona Public Service Company of a Partial Variance to A.A.C. R14-2-1606(B) and for Approval of a Purchased Power Agreement at p. 6.

⁵³ The Value Line Investment Survey, p. 701 (January 5, 2001).

1 Resources and Avista Corporation, locked in power needs with the intention of
2 selling any excess energy at a profit in the wholesale market during the summer,
3 primarily to help offset prior deferrals. As it turned out, this strategy only served
4 to magnify their cash drain and inflate the balance of deferred power costs.
5 Similarly, *Megawatt Daily* reported in June 2001 that contemporaneous long-term
6 contracts negotiated by the State of California contained an average price of
7 \$138 per Megawatt-hour.⁵⁴ But the fact that events again took an unexpected
8 turn during the summer of 2001 does not mean that the decisions were not
9 reasonable based on the best available information at the time.

10 On a personal note, I recall attending board meetings in the spring of 2001
11 at Georgia System Operations Corporation, where we were briefed by
12 management about the challenges expected in the summer of 2001 based on the
13 difficulties experienced in the prior year. We were told of the tremendous
14 investments being made by our member systems to accelerate construction
15 schedules to bring plants online in time for the summer peak of 2001. The Board
16 authorized significant investments on our part to control the hundreds of
17 megawatts of distributed generation being installed to shore up the electrical
18 systems during the emergencies expected in the coming summer. As events
19 turned out, 2001 was one of the mildest on record in our service area and none
20 of the distributed generators so hastily installed were needed. Were we
21 imprudent in preparing to keep the lights on in Georgia? No. We, like the AED,
22 had to plan for the worst and hope for the best.

23 With respect to APS' proposed contract with PWCC to meet its standard
24 offer service, it is important to recognize that this agreement does not insulate
25 customers from potential volatility in fuel or purchased power costs, as does the
26 New Contract. As APS explained in its October 2001 request for contract
27 approval, while the base energy price under the proposed agreement would
28 remain fixed during the contract term, the variable price component "*is subject to*
29 *an annual surcharge adjustment for actual and forecast variations (from the*

⁵⁴ "Generators Say California Not Yet in the Clear", *Megawatt Daily* (June 11, 2001).

1 *projected baseline or "base" energy price) in the cost of fuel used to provide or*
2 *procure the Dedicated Units Energy Products".⁵⁵ Indeed, APS noted in its*
3 *request that the price projection under the proposed contract "assumes no*
4 *material deviation during the years 2002-2004 from the base projections of fuel*
5 *costs for the Dedicated Units Energy Products". Similarly, if any of PWCC's*
6 *suppliers were to default in their obligations to provide standard offer power to*
7 *APS, PWCC would pursue "available and feasible" remedies; although the full*
8 *cost of replacement energy would be a monthly pass-through to APS.⁵⁶ This is a*
9 *far cry from the insulation afforded to the AED's customers by the fixed-rate*
10 *pricing provisions under the New Contract and illustrates the fallacy of Dr.*
11 *Rosen's simplistic comparisons.*

12 **Q. Is Dr. Rosen able to predict that the New Contract will prove uneconomic**
13 **over the remainder of its term?**

14 A. Absolutely not. Dr. Rosen grants:

15 There was no way for Citizens to know during the winter of 2001
16 when the high bills from APS would end, and when market prices in
17 the West would fall.⁵⁷

18 If it was impossible to predict wholesale prices for a few months into the future in
19 2001, it is more daunting to project more than six years into the future in the
20 winter of 2002. With the collapse of Enron, the financial problems of other
21 independent power producers, and other global uncertainties triggered by the
22 War on Terrorism, no one can predict the future course of wholesale electric
23 prices. We simply will not know whether the New Contract has been more
24 favorable until the future comes. In the meantime, the stability and certainty

⁵⁵ Docket No. E-01345A-01-____, Request of Arizona Public Service Company of a Partial Variance to A.A.C. R14-2-1606(B) and for Approval of a Purchased Power Agreement at p. 11 (emphasis added).

⁵⁶ *Ibid.* at pp. 12-13 (emphasis added).

⁵⁷ Testimony of Richard A. Rosen at p. 10.

1 afforded by the New Contract is a significant advantage to the AED's
2 customers.⁵⁸

3 **Q. What other examples illustrate the perils of predicting future market**
4 **prices?**

5 A. In its October 1998 report on purchased gas adjustor mechanisms, the Staff
6 commented on the volatility of natural gas prices observed in the winter of 1996-
7 1997, and concluded that such a dramatic rise was unlikely to reoccur:

8 The extreme run up in spot market gas prices in the 1996-1997
9 winter season was also due to a number of national factors
10 including low gas storage levels and several months of colder than
11 normal weather. It appears unlikely that such a combination of
12 circumstances will occur again soon, although natural gas spot
13 market prices continue to exhibit volatility.⁵⁹

14 Of course, as events played out these predictions were proven shortsighted.
15 Just two years after the Staff issued their conclusion that prices were unlikely to
16 experience a significant run up any time soon, spot market gas prices spiked to
17 unprecedented levels. As Staff recognized in a December 2001 report:

18 During this year natural gas prices have risen to record heights
19 before moderating... It should be noted that the enormous and
20 largely unanticipated increase in natural gas prices through 2000
21 and early 2001 created a situation where no PGA mechanism is
22 likely to perform as all parties wish it would... If anything, this
23 situation has highlighted the need for further efforts to address price
24 stability issues in the gas procurement process...⁶⁰

25 Staff's experience with the vagaries of energy markets illustrates the
26 difficulties associated with making market forecasts, even spanning just a two-
27 year horizon. Given the pace of change in the electric power industry and the

⁵⁸ Dr. Rosen's suggestion that stability has less value than lower rates (p. 21) assumes that rates will be lower. I don't believe the AED's customers can take Dr. Rosen's assurances to the bank.

⁵⁹ Docket No. G-00000C-98-0568, Staff Report on Purchased Gas Adjustor Mechanisms, p. 23 (October 19, 1998).

⁶⁰ Docket No. G-00000C-98-0568, Staff Report on the Rolling Average PGA Mechanism, p. 6 (December 2001).

1 rapid and dramatic shifts in market prices observed historically, the remaining six
2 year term of the New Contract is light years away. Given the uncertainties
3 inherent in forecasting, it is not surprising that the Staff and the ACC have
4 recognized the importance of considering price stability in procuring energy
5 supplies.⁶¹ Consistent with this policy, the AED took concrete steps to address
6 price stability during a time of unprecedented uncertainty regarding wholesale
7 power costs in negotiating the New Contract.

G. Implications for the AED's Financial Integrity

8 **Q. Briefly summarize the recommendations of Ms. Lee and Dr. Rosen**
9 **concerning under-recovered power costs accumulated in the PPFAC bank.**

10 A. Based on her contention that the AED's power costs were higher than necessary
11 due to inadequate power supply management and insufficient actions to mitigate
12 against escalating wholesale electricity prices, Ms. Lee recommended that \$7
13 million of unrecovered power costs should be disallowed. In addition, of the \$87
14 million balance in the PPFAC bank, Ms. Lee recommended that the AED be
15 denied the opportunity to collect a further \$49 million until it has "pursued
16 overbilling issues". Ms. Smith granted that the AED should be allowed to collect
17 the remaining balance in the PPFAC over six years, but recommended that no
18 carrying cost on this amount be allowed as "an additional penalty".

19 Similarly, Dr. Rosen concluded that the AED "did not take appropriate
20 steps to mitigate" the PPFAC balance and estimated that the AED should be
21 permitted to collect approximately \$17 million of the unrecovered power costs
22 currently accumulated in the PPFAC bank. Dr. Rosen accepted the AED's
23 proposed 6 percent carrying cost rate on this \$17 million balance. Apparently,
24 Dr. Rosen would make no adjustment to the PPFAC to reflect the prices the AED
25 is actually paying for power under the New Contract.

⁶¹*Ibid.* at p. 4. Also see Docket No. G-00000C-98-0568, Staff Report on Purchased Gas Adjustor Mechanisms, p. 8 (October 19, 1998).

1 **Q. What are the financial implications of these recommendations for the AED?**

2 A. The recommendations of both Ms. Smith and Dr. Rosen would spell financial
3 disaster for the AED and imply a level of uncertainty diametrically opposed to its
4 past treatment as a relatively low risk, stand-alone utility. Apart from the \$7
5 million in unrecovered power costs that Ms. Smith would disallow, she
6 recommends that \$49 million of the cost accumulated in the PPFAC bank be
7 deferred indefinitely, with the AED being forced to bear all costs associated with
8 financing this balance. Even for the remaining \$31 million balance in the PPFAC
9 bank that Ms. Smith would allow the AED to collect, she recommends that no
10 carrying charges be considered. But Ms. Smith failed to consider the
11 implications of her recommendations on the financial integrity of the AED.

12 In the AED's 1995 rate case (Docket No. E-1032-95-433), the ACC
13 determined that total investment in rate base associated with the system
14 amounted to approximately \$90.4 million, with 51 percent of this amount, or
15 \$46.1 million, representing common equity capital invested in the utility. In other
16 words, Ms. Smith proposes to deny the AED a return on an outstanding balance
17 of deferred power costs that exceeds total common equity by a factor of 1.74
18 times.⁶² As shown on Schedule WEA-1, the capitalization and component costs
19 approved by the ACC authorized an overall rate of return of 8.91 percent. Ms.
20 Smith's proposal to deny a return on \$80 million of deferred power costs included
21 in the PPFAC bank would reduce that overall rate of return for the AED to 4.73
22 percent. A rate of return of this magnitude is below the prevailing yields available
23 from long-term Treasury bonds, which averaged 5.59 percent during January
24 2002⁶³. Apart from resulting in a return below what is widely considered to be a
25 risk-free rate, the rate of return produced by Ms. Smith's recommendations falls
26 woefully short of that found just and reasonable by the ACC in the AED's last rate
27 case.

⁶² Calculated by dividing the total PPFAC bank balance at May 2001 (excluding Ms. Smith's \$7 million disallowance) of \$80 million by total common equity of \$46.1 million.

⁶³ Moody's Credit Perspectives (February, 18, 2002).

1 **Q. How else can the impact of Staff's recommendations be evaluated?**

2 A. Bond ratings provide the most objective guide to a utility's financial integrity, and
3 one of the most important quantitative factors in determining a utility's bond rating
4 is its pre-tax coverage ratio, which is a measure of the protection available to pay
5 interest expense from operations. Schedule WEA-2 compares the pre-tax
6 interest coverage ratio that results from the returns authorized by the ACC's
7 decision in Docket No. E-1032-95-433 with that resulting from Ms. Smith's
8 recommendations in this case. Under Ms. Smith's proposed treatment, the AED
9 would be responsible for financing \$80 million in deferred PPFAC power costs
10 without the benefit of earning a return on this investment.⁶⁴ As shown on
11 Schedule WEA-1, while the return authorized in the AED's last rate case
12 produces pre-tax interest coverage of 3.83 times, assuming the AED finances the
13 \$80 million in deferred costs at its embedded cost of debt, Ms. Smith's proposed
14 treatment of the PPFAC bank balance would result in a coverage ratio of only
15 1.25 times.

16 **Q. How does this result impact AED's financial integrity?**

17 A. A coverage ratio of 1.25 times is far below the level required to maintain the
18 AED's creditworthiness. Based on the financial benchmark ratios published by
19 Standard & Poor's Corporation (S&P), a pre-tax interest coverage ratio of at least
20 3.07 times is required to support a triple-B bond rating for an electric utility with
21 an "average" business position ranking. The 1.25 times coverage ratio resulting
22 from Ms. Smith's recommendations is sufficient to support only a single-B rating,
23 which falls far below the investment grade scale. The junk bond rating driven by
24 the Staff's recommendations would not allow the AED to maintain its financial
25 integrity or its ability to attract capital on reasonable terms.

⁶⁴ While Ms. Smith recommends that \$31 million in the PPFAC bank be recovered from customers, she recommended that the AED be denied carrying charges on this balance.

1 **Q. Do you agree with Ms. Smith's proposal to deny the AED the opportunity to**
2 **earn carrying costs on deferred balance in the PPFAC bank?**

3 A. No. While Ms. Smith recommends denying carrying costs as "an additional
4 punishment", as demonstrated above, the level of punishment implied by her
5 proposals would make even an English schoolmaster blush. As Dr. Rosen's
6 recommendations recognize, there is no justifiable reason to deny the AED
7 carrying charges on reasonable and necessary expenses incurred for the benefit
8 of ratepayers. Moreover, the 6 percent carrying cost rate requested by the AED
9 already falls below the 8.91 percent overall rate of return authorized by the ACC.
10 Staff has recognized that this alone provides the utility an incentive to address
11 the underlying cause of the deferral:

12 At the time the application of interest to the PGA bank balance was
13 approved, it was recognized that the interest rate to be used would
14 not necessarily reflect the borrowing costs of the utilities. There
15 may even be some benefit in having the interest rate be less than
16 the utility's cost of borrowing in that the utility would be given an
17 incentive not to let the bank balance become overly large without
18 taking action to address it.⁶⁵

19 Also, by the time this proceeding concludes, the AED will have already incurred
20 over \$10 million in unrecoverable costs in financing the power cost deferrals
21 during the pendency of this matter.

22 Finally, while much attention has been given to recent declines in short-
23 term interest rates and Treasury bond yields, the average yield on long-term
24 public utility bonds is currently just above the level in January 1997 when the
25 ACC issued its order in Docket No. E-1032-95-433. Similarly, investors'
26 heightened concerns regarding the risks facing firms in the power industry since
27 the California crisis and the collapse of Enron have almost certainly led to an
28 increase in their required rates of return for electric utilities. Contrary to Ms.
29 Smith's proposal, a carrying charge rate of 6 percent on deferred PPFAC bank

⁶⁵ Docket No. G-00000C-98-0569, Staff Report on the Rolling Average PGA Mechanism, p. 3
(December 2001).

1 balances is more than reasonable and already understates the AED's overall
2 cost of funds.

3 **Q. How does the financial integrity impact of Dr. Rosen's recommendations**
4 **compare with that implied by Staff's proposals?**

5 A. It is far worse. As noted earlier, Dr. Rosen recommends that all but \$17 million of
6 the balance accumulated in the PPFAC bank be disallowed. Thus, based on the
7 \$87 million Ms. Smith attributes to the PPFAC bank, Dr. Rosen proposes that the
8 ACC disallow expenses equal to over one and a half times the total equity
9 authorized for the AED's stand-alone system in its last rate proceeding. Indeed,
10 the disallowances recommended by Dr. Rosen equate to over 77 percent of the
11 AED's total investment in rate base. Moreover, Dr. Rosen would not adjust the
12 PPFAC to reflect the 5.88 ¢/kilowatt-hour rate under the New Contract, so that
13 the AED would continue to absorb a loss on every kilowatt-hour delivered to its
14 customers.

15 **Q. Would the end results implied by the recommendations of Ms. Smith and**
16 **Dr. Rosen be consistent with accepted regulatory and economic**
17 **standards?**

18 A. No. To be consistent with sound regulatory economics and required legal
19 standards, a utility must be permitted the opportunity to earn a return sufficient to
20 (1) fairly compensate capital invested in the utility, (2) enable the utility to offer a
21 return adequate to attract new capital on reasonable terms, and (3) maintain the
22 utility's financial integrity. The ACC has recognized that these standards may
23 constrain its regulatory actions and that its decisions have direct implications for
24 the financial health of the utilities under its jurisdiction:

25 The broad constitutional mandate of the Commission is set forth in
26 Article 15, Section 3 of the Constitution of the State of Arizona.

27 The Corporation Commission shall have full power to and
28 shall prescribe just and reasonable classifications to be used
29 and just and reasonable rates and charges to be made and
30 collected by public service corporations within the State.

31 The operating language "just and reasonable" as applied to rates is
32 like the proverbial sword that cuts both ways. Rates may be

1 unreasonably low and therefore insufficient to yield a fair rate of
2 return on fair value or may be unreasonably high permitting the
3 utility excessive or windfall profits at the expense of ratepayers.
4 While the Commission is by law the arbiter of what constitutes just
5 and reasonable, the Commission's effectiveness in performing its
6 function may ultimately be reflected in a given utility's cost of
7 borrowing money relative to other utilities of the same nature.
8 Therefore, this Commission can best meet its mandate by
9 scrutinizing the utility's rates and charges with respect to
10 efficiencies and economies in operation while establishing a
11 regulatory climate conducive to stability of earnings.⁶⁶

12 These standards address the basic concerns of treating investors in a utility
13 fairly, as well as ensuring that the utility can obtain the capital necessary to
14 provide acceptable levels of service to customers.

15 As noted above, the Staff's recommendations dramatically lower the
16 AED's earnings while producing coverage ratios far below the acceptable range
17 for an investment grade utility and eroding the Company's equity balance when
18 viewed as a stand-alone utility, as has been the ACC's practice. Dr. Rosen's
19 proposals are even more extreme and both witnesses' recommendations would
20 destroy the AED's financial viability and ability to attract capital on reasonable
21 terms. Recommendations that imply rates of return below the risk-free rate, lead
22 to junk-bond ratings, or effectively wipe out a utility's entire common equity
23 investment clearly fail the financial integrity end-result test prescribed by the
24 Arizona Constitution and would be contrary to any notion of fair treatment.

25 **Q. What else should be considered in evaluating Staff's and RUCO's**
26 **proposals?**

27 A. Given the social and economic importance of the electric utility industry, it is
28 essential to maintain reliable and economical service to all consumers. While the
29 AED remains committed to deliver reliable electric service at the lowest possible
30 price, a utility's ability to fulfill its mandate can be compromised if it lacks the
31 necessary financial wherewithal. Exposing utility investors to the extraordinary

⁶⁶ ACC Decision No. 49333 at p. 3 (September 13, 1978).

1 risks associated with unprecedented and prolonged volatility in purchased power
2 costs by second-guessing management's' negotiation strategy would send the
3 wrong signal to investors. Because of the unrest in Western power markets,
4 investors are already justifiably concerned regarding the impact on the financial
5 integrity of the region's utilities. As S&P observed:⁶⁷

6 Utilities with any degree of market purchase or natural gas
7 exposure are feeling financial strain... Standard & Poor's expects
8 that cash reserves particularly should be evaluated to determine
9 whether they are sufficient to cover each utility's outstanding risk.

10 The capital markets are well aware that cost deferral is not equivalent to cash in
11 the bank and, with the extreme prices and regulatory uncertainty over potential
12 under-recovery, maintaining liquidity has become increasingly important. In a
13 review of the situation in Western energy markets, Moody's affirmed this
14 concern.⁶⁸

15 ...careful attention to ensure adequate liquidity, central to any good
16 credit story, is heightened because unexpected increases in
17 demand for capital can occur at any time when so much change is
18 happening.

19 Value Line also noted that the accounting accrual of excess purchased power
20 costs is not equivalent to collecting these amounts from ratepayers, observing
21 that "it's one thing for a utility to defer costs on its books, and another for it to
22 recover them."⁶⁹

23 **Q. What lessons can be learned from events in California?**

24 A. The recent crisis in California provides a dramatic illustration of the high costs
25 that all stakeholders must bear when a utility's financial integrity is compromised.
26 As utilities were forestalled from recovering the costs of purchased power that

⁶⁷ *Standard & Poor's Corporation*, "Public Power Companies in Northwest Increase Rates Due to Low Water, Skyrocketing Prices", *Infrastructure Finance*, p. 2 (January 18, 2001).

⁶⁸ *Moody's Investors Service*, "The Northwest Region's Energy Supply Situation", *Special Comment*, p. 6 (January 2001).

⁶⁹ *The Value Line Investment Survey*, p. 1749 (February 16, 2001).

1 they were obligated to buy to serve their customers and denied the opportunity to
2 earn risk-equivalent rates of return, they were cut off from access to capital.
3 California's economy has been jolted as cash-strapped utilities have been unable
4 to buy enough wholesale power to avoid curtailments and rolling blackouts.
5 Moreover, while the impact of the utilities' deteriorating financial condition was
6 felt swiftly, California stakeholders have discovered first hand how difficult and
7 complex it can be to remedy the situation after the fact. Arizona's utility
8 stakeholders have been largely sheltered from the devastation that roiled
9 California. However, through a series of events beyond the control of either the
10 AED or the ACC, this utility has been severely impacted. Considering investors'
11 heightened awareness of the risks associated with volatile wholesale power
12 markets and the damage that results when a utility's financial flexibility is
13 compromised, supportive regulation is perhaps more crucial now than at any time
14 in the past.

15 **Q. Does this conclude your direct testimony?**

16 **A.** Yes, it does.

APPENDIX A

Qualification of William E. Avera

WILLIAM E. AVERA

FINCAP, INC.
Financial Concepts and Applications
Economic and Financial Counsel

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Austin, Texas 78751
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Summary of Qualifications

Ph.D. in economics and finance; Chartered Financial Analyst (CFA) designation; extensive expert witness testimony before courts, regulatory agencies, alternative dispute resolution panels, and legislative committees throughout the U.S. and Canada. Testimony on economic and financial issues, including antitrust, damages, cost of capital, and business valuation. Lectured in executive education programs around the world; undergraduate and graduate teaching in business and economics; leadership positions in government, industry, academia, and the military.

Employment

Principal,
FINCAP, Inc.
(Sep. 1979 to present)

Financial, economic and policy consulting to business and government. Perform business and public policy research, cost/benefit analyses and financial modeling, valuation of businesses, estimation of damages, and industry studies. Provide counseling and educational services, participate in negotiations, and serve as expert witness before regulatory agencies, legislative committees, arbitration panels, and courts.

*Director, Economic Research
Division,*
Public Utility Commission of Texas
(Dec. 1977 to Aug. 1979)

Responsible for research and testimony preparation on rate of return, rate structure, and econometric analysis dealing with energy, telecommunications, water and sewer. Testified in major rate cases and appeared before legislative committees as Chief Economist for regulatory agency. Administered state and federal grant funds. Communicated frequently with political leaders and representatives from consumer groups, media, and investment community.

Manager, Financial Education,
International Paper Company
New York City
(Feb. 1977 to Nov. 1977)

Directed corporate education programs in accounting, finance, and economics. Developed course materials, recruited and trained instructors, maintained liaison within the company and with academic institutions. Prepared operating budget and designed financial controls for corporate professional development program.

Lecturer in Finance,
The University of Texas at Austin
(Sep. 1979 to May 1981)
Assistant Professor of Finance,
(Sep. 1975 to May 1977)

Taught graduate and undergraduate courses in financial management and investment theory. Conducted research in business and public policy. Named Outstanding Graduate Business Professor and received various administrative appointments.

Assistant Professor of Business,
University of North Carolina at
Chapel Hill
(Sep. 1972 to Jul. 1975)

Taught in BBA, MBA, and Ph.D. programs. Created project course in finance, Financial Management for Women, and participated in developing Small Business Management sequence. Organized the North Carolina Institute for Investment Research, a group of financial institutions that supported academic research. Faculty advisor to the Media Board, which funds student publications and broadcast stations.

Education

Ph.D., Economics and Finance,
University of North Carolina at
Chapel Hill
(Jan. 1969 to Aug. 1972)

Elective courses included financial management, public finance, monetary theory, and econometrics. Awarded the Stonier Fellowship by the American Bankers' Association and University Teaching Fellowship. Taught statistics, macroeconomics, and microeconomics.

Dissertation: *The Geometric Mean Strategy as a Theory of Multiperiod Portfolio Choice*

B.A., Economics,
Emory University, Atlanta, Georgia
(Sep. 1961 to Jun. 1965)

Active in extracurricular activities, president of the Barkley Forum (debate team), Emory Religious Association, and Delta Tau Delta chapter. Individual awards and team championships at national collegiate debate tournaments.

Professional Associations

Received Chartered Financial Analyst (CFA) designation in 1977.

Former Professional Association Positions: ρ Vice President for Membership, Financial Management Association ρ President, Austin Chapter of Planning Executives Institute ρ Board of Directors, North Carolina Society of Financial Analysts ρ Candidate Curriculum Committee, Association for Investment Management and Research ρ Executive Committee of Southern Finance Association ρ Vice Chair, Subcommittee on Economics and National Association of Regulatory Utility Commissioners (NARUC) ρ Appointed to NARUC's Technical Subcommittee on the National Energy Act.

Teaching in Executive Education Programs

University-Sponsored Programs: Central Michigan University, Duke University, Louisiana State University, National Defense University, National University of Singapore, Texas A&M University, University of Kansas, University of North Carolina, University of Texas.

Business- and Government-Sponsored Programs: Advanced Seminar on Earnings Regulation, American Public Welfare Association, Association for Investment Management and Research, Congressional Fellows Program, Cost of Capital Workshop, Electricity Consumers Resource Council, Financial Analysts Association of Indonesia, Financial Analysts Review at Albuquerque, Denver, Raleigh and Salt Lake City, Financial Analysts Seminar at Northwestern University, Governor's Executive Development Program of Texas, Louisiana Association of Business and Industry, National Association of Purchasing Management, National Association of Tire Dealers, Planning Executives Institute, School of Banking of the South, Stock Exchange of Thailand, Texas Association of State Sponsored Computer Centers, Texas Bankers' Association, Texas Bar Association, Texas Savings and Loan League, Texas Society of CPAs, Tokyo Association of Foreign Banks, Union Bank of Switzerland, U.S. Department of State, U.S. Navy, U.S. Veterans Administration, and major corporations.

Presented papers for Mills B. Lane Lecture Series at the University of Georgia and Heubner Lectures at the University of Pennsylvania. Taught graduate courses in finance and economics in evening program at St. Edward's University in Austin from January 1979 through 1998.

Expert Witness Testimony

Testimony before administrative agencies addressed cost of capital, rate design, and other economic and financial issues.

Federal Agencies: Federal Communications Commission, Federal Energy Regulatory Commission, Surface Transportation Board, Interstate Commerce Commission, and the Canadian Radio-Television and Telecommunications Commission.

State Regulatory Agencies: Alaska, Arkansas, California, Colorado, Connecticut, Delaware, Florida, Hawaii, Idaho, Illinois, Indiana, Kansas, Maryland, Missouri, Nevada, New Mexico, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Texas, Virginia, Washington, West Virginia, and Wisconsin.

Testimony before federal and state courts, arbitration panels, and alternative dispute resolutions involving damages, valuation, antitrust liability, fiduciary duties, and other economic and financial issues.

Other Professional Activities

ρ Board Member, Georgia System Operations Corporation (electric system operator for Oglethorpe Power Corporation) ρ Co-chair, Synchronous Interconnection Committee, appointed by Governor George Bush and Public Utility Commission of Texas ρ Appointed to Organic Livestock Advisory Committee by Texas Agricultural Commissioner Susan Combs ρ Appointed to research team for Texas Railroad Commission study, *The UP/SP Merger: An Assessment of the Impacts on the State of Texas* ρ Member of team appointed by Hawaii Public Utilities Commission to review affiliate relationships of Hawaiian Electric Industries ρ Consultant to Public Utility Commission of Texas

on cogeneration policy and other matters ρ Consultant to Public Service Commission of New Mexico on cogeneration policy ρ Evaluator of Energy Research Grant Proposals for Texas Higher Education Coordinating.

Community Activities

ρ Board Member, Sustainable Food Center ρ Chairman, Energy Task Force, Greater Austin-San Antonio Corridor Council ρ Chair, Board of Deacons, Finance Committee, and Elder, Central Presbyterian Church of Austin ρ Founding Director, Orange-Chatham County Legal Aid.

Military

ρ Captain, U.S. Naval Reserve (retired after 28 years service) ρ Commanding Officer, Naval Special Warfare (SEAL) Engineering Support Unit ρ Officer-in-charge of SWIFT patrol boat in Vietnam ρ Enlisted service as weather analyst.

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AUTHORIZED OVERALL RATE OF RETURNACC Authorized (a)

| <u>Component</u> | <u>Invested Capital</u> | | <u>Cost Rate</u> | <u>Return</u> |
|---------------------------------------|-------------------------|---------------|------------------|---------------------|
| | <u>%</u> | <u>Amount</u> | | |
| Long-term Debt | 43% | \$ 38,858,674 | 7.23% | \$ 2,809,482 |
| Preferred Stock | 6% | \$ 5,422,141 | 5.75% | \$ 311,773 |
| Common Equity | 51% | \$ 46,088,195 | 10.70% | \$ 4,931,437 |
| Total | | \$ 90,369,010 | | \$ 8,052,692 |
| Implied Overall Rate of Return | | | | <u>8.91%</u> |

RESULTING OVERALL RATE OF RETURNSmith Recommendations (b)

| <u>Component</u> | <u>Invested Capital</u> | | <u>Cost Rate</u> | <u>Return</u> |
|---------------------------------------|-------------------------|----------------|------------------|---------------------|
| | <u>%</u> | <u>Amount</u> | | |
| PPFAC Balance | | | | |
| Deferred | | \$ 49,000,000 | 0% | \$ - |
| Allowed | | \$ 31,000,000 | 0% | \$ - |
| | 47% | \$ 80,000,000 | | |
| Long-term Debt | 23% | \$ 38,858,674 | 7.23% | \$ 2,809,482 |
| Preferred Stock | 3% | \$ 5,422,141 | 5.75% | \$ 311,773 |
| Common Equity | 27% | \$ 46,088,195 | 10.70% | \$ 4,931,437 |
| Total | | \$ 170,369,010 | | \$ 8,052,692 |
| Implied Overall Rate of Return | | | | <u>4.73%</u> |

(a) Arizona Corporation Commission. Decision No. 59951, Docket No. E-1032-95-433.

(b) PPFAC Balance from Testimony of Ms. Lee Smith (excluding \$7 million proposed disallowance) added to invested capital.

IMPLIED COVERAGE RATIOS

| Component | | (a) | (a) | (b) | Pre-tax Cost | Pre-tax Return |
|-----------------|-----|---------------------------|--------|---------------|--------------|----------------|
| | | Invested Capital (a) % | Amount | Cost Rate (a) | | |
| Long-term Debt | 43% | \$ 38,858,674 | 7.23% | 1.0000 | 7.23% | \$ 2,809,482 |
| Preferred Stock | 6% | \$ 5,422,141 | 5.75% | 1.5152 | 8.71% | \$ 472,383 |
| Common Equity | 51% | \$ 46,088,195 | 10.70% | 1.5152 | 16.21% | \$ 7,471,874 |
| | | \$ 90,369,010 | | | | \$ 10,753,740 |

IMPLIED COVERAGE - ACC ORDER (a)

| | |
|-----------------------|---------------------|
| Total Pre-Tax Return | \$ 10,753,740 |
| Interest Charges | \$ 2,809,482 |
| Coverage Ratio | <u>3.83X</u> |

IMPLIED COVERAGE - STAFF RECOMMENDATION

| | |
|---------------------------------|---------------------|
| Total Allowed Pre-Tax Return | \$ 10,753,740 |
| Interest Charges | |
| Long-term Debt | \$ 2,809,482 |
| Deferred PPFAC Bank Balance (c) | |
| Amount | \$ 80,000,000 |
| Cost Rate | 7.23% |
| | <u>\$ 5,784,000</u> |
| Total Interest Charges | \$ 8,593,482 |
| Coverage Ratio | <u>1.25X</u> |

(a) Arizona Corporation Commission. Decision No. 59951, Docket No. E-1032-95-433.

(b) Assumes tax rate of 34 percent.

(c) From Testimony of Ms. Lee Smith. Excludes \$7 million disallowance.