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BEFORE THE ARIZONA CORPORATION COMMISSION

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WILLIAM A. MUNDELL
Chairman
JIM IRVIN
Commissioner
MARC SPITZER
Commissioner

2002 NOV -5 P 2: 24

AZ CORP COMMISSION
DOCUMENT CONTROL

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 APPROVE
GUIDELINES FOR THE RECOVERY OF COSTS
INCURRED IN CONNECTION WITH ENERGY
RISK MANAGEMENT INITIATIVES.

Docket No. E-01032C-00-0751

STAFF'S NOTICE OF FILING
SUPPLEMENTAL TESTIMONY

In accordance with the September 27, 2002 Procedural Order, the Staff hereby files the
supplemental testimony and exhibits of Lee Smith.

DATED this 5th day of November, 2002.

ARIZONA CORPORATION COMMISSION

By Christopher C. Kempley
Christopher C. Kempley
Chief Counsel
Legal Division
1200 West Washington
Phoenix, AZ 85007
(602) 542-3402

Arizona Corporation Commission
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1 The original and ten copies of the
2 foregoing were filed this 5th day of
3 November, 2002, with:

3 Docket Control
4 Arizona Corporation Commission
5 1200 West Washington Street
6 Phoenix, Arizona 85007

6 COPIES of the foregoing were mailed
7 this 5th day of November, 2002 to:

8 Robert J. Metli
9 Cheifetz & Iannitelli, P.C.
10 3238 North 16th Street
11 Phoenix, AZ 85016
12 Attorneys for Citizens Communications Company

11 Daniel W. Pozefsky
12 RUCO
13 2828 N. Central Ave., Suite 1200
14 Phoenix, Arizona 85004

14 John White
15 Christine L. Nelson
16 Deputy County Attorney
17 P.O. Box 7000
18 Kingman, Arizona 86402

17 Walter W. Meek
18 AUIA
19 2100 N. Central Ave., Suite 210
20 Phoenix, Arizona 85004

20 Holly J. Hawn
21 Santa Cruz Deputy County Attorney
22 2150 N. Congress Drive, Ste. 201
23 Nogales, AZ 85621

23 Raymond S. Heyman
24 Michael W. Patten
25 ROSHKA HEYMAN & DeWULF
26 400 East Van Buren Street, Ste. 800
27 Phoenix, AZ 85004
28 Attorneys for Mohave and Santa Cruz Counties

28 ...

1 Marshall Magruder
2 Lucy Magruder
P. O. Box 1267
3 Tubac, AZ 85646-1267

4 Jose L. Machado
777 North Grand Avenue
5 Nogales, AZ 85621
6 Attorney for City of Nogales, AZ

7 L. Russell Mitten
Citizens Communications Company
8 3 High Ridge Park
9 Stamford, CT 06905

10 John D. Draghi
Huber, Lawrence & Abell
11 605 Third Avenue
12 New York, NY 10158

13 *Nancy Roe*

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BEFORE THE ARIZONA CORPORATION COMMISSION

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2002 NOV -5 P 2: 23

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DOCKET NO. E-01032C-00-0751

SUPPLEMENTAL TESTIMONY

OF

LEE SMITH

ON BEHALF OF

ARIZONA CORPORATION COMMISSION STAFF

November 5, 2002

1 **I. INTRODUCTION AND SUMMARY**

2

3 **Q. What is your name and business address?**

4 A. My name is Lee Smith, and I work for La Capra Associates, 333 Washington
5 Street, Boston, Massachusetts.

6

7 **Q. On whose behalf are you testifying?**

8 A. I am testifying on behalf of the Arizona Corporation Commission Utilities
9 Division Staff.

10

11 **Q. Did you file direct testimony and Surrebuttal Testimony in this Docket?**

12 A. Yes. I filed Direct Testimony on February 8, 2002, and Surrebuttal Testimony on
13 March 13, 2002.

14

15 **Q. What is the purpose of this Supplemental Testimony?**

16 A. This testimony will present my recommendations to the Commission, summarize
17 earlier testimony, and incorporate certain new information which has been
18 provided since Staff Surrebuttal Testimony was filed.

19

20 **Q. What were the central points of your original testimony?**

21 A. I testified that I found that Citizens should have known that there were significant
22 problems in the Old Contract that could result in Citizens' power costs rising if
23 market prices increased. Testimony by me and Mr. Smith also explained that
24 Citizens should have known that market prices could rise significantly in the
25 summer of 2000. I testified as to several actions that Citizens could have taken
26 but did not take, finding that Citizens did not take appropriate steps to mitigate the
27 potential for dramatic price increases. As a result, I recommended a disallowance
28 of the under-recovered power costs. In addition, although Citizens testified that it
29 believes it had been overbilled under the Old Contract, it has not pursued two
30 potential overbilling issues to the fullest. I recommended that Citizens should be
31 required to defer collection of the amount of dollars that could be disputed until it

1 had made every effort to obtain relief from FERC or the courts, and that it not be
2 allowed a carrying charge on this amount.

3
4 **Q. Please summarize Citizens' requests in this proceeding.**

5 A. Citizens is requesting several changes to its Purchased Power Fuel Adjustment
6 Clause (PPFAC). These include:

- 7 1. a factor that would collect \$87 million, over 7 years, of under-recovered
8 fuel costs (resulting from its Old Contract) plus additional under-
9 recoveries incurred under the New Contract, resulting in a total under-
10 recovery by December 2002 projected to be \$121 million, with a carrying
11 charge of 6%,
- 12 2. an increase in the basic factor to reflect the fixed pricing in the New
13 Contract with APS, and
- 14 3. a small increase in the basic factor to reflect increased transmission costs.

15
16 The foregoing, taken together, result in an adjustment factor of \$.030852.

17
18 **Q. Please summarize your recommended response to Citizens' requests.**

19 A. My recommendations include:

- 20 1. a denial of \$7 million of costs that could have been avoided by reasonable
21 actions by Citizens,
- 22 2. a deferral of \$70 million of disputed charges until Citizens fully pursues
23 its claim that it was overbilled according to the Old Contract,
- 24 3. an increase in the PPFAC to collect the remaining under-recovery under
25 the Old Contract, of \$10.3 million, over 2 years,
- 26 4. a small increase in the PPFAC to cover increased transmission costs.

27
28 I also recommend that the PPFAC not be increased to cover power costs under
29 the New Contract until the Commission has fully addressed this contract
30 under a separate proceeding.

1 **Q. Have these recommendations changed from your earlier testimony?**

2 A. Yes. My original testimony recommended that the PPFAC be allowed to increase
3 to reflect the higher costs of the New Contract, but also that the prudence of this
4 contract be addressed in the Company's next rate case. In this testimony I am
5 recommending that the PPFAC *not* be increased to cover under-recoveries from,
6 and higher ongoing costs in, the New Contract. In addition, I am now proposing a
7 shorter recovery period for the amount that I am recommending in this proceeding
8 for recovery.

9
10 **Q. Please summarize the reason for these changes in your recommendations.**

11 A. New information has raised additional questions regarding the prudence of the
12 Company in signing the New Contract. In addition, since an additional six
13 months has passed, the amount of under-recovery due to the New Contract has
14 increased. This makes me more reluctant to recommend recovery of these costs
15 from customers when the Commission has not approved the prudence of the
16 underlying contract. My recommended recovery period has been shortened,
17 because the total amount for which I recommend immediate recovery has been
18 decreased.

19

20 **II. THE PROBLEMS WHICH GAVE RISE TO THIS PROCEEDING**

21

22 **Q. What was the initial problem that gave rise to this proceeding?**

23 A. Citizens' power bills rose dramatically in the summer of 2000, so that its existing
24 PPFAC did not recover costs.

25

26 **Q. What gave rise to the original large undercollection?**

27 A. The Old Contract with APS included floor price provisions which became the
28 provisions beginning in 1998 and caused the contract prices to increase
29 dramatically, particularly in 2000 and 2001. Beginning in May of 2000, these
30 price increases caused Citizens' bills under the Old Contract to increase
31 dramatically, such that the PPFAC and the amount of power costs recovered in

1 base rates did not recover billed power costs. This under-recovery persisted
2 through May 2001.

3
4 **Q. What has happened since June 2001?**

5 A. In July 2001, Citizens and APS entered into a New Contract, replacing the Old
6 Contract (new pricing provisions were retroactive to June 2001). This New
7 Contract, while addressing some of the concerns with the Old Contract, also
8 results in costs well above that which are being recovered within the current
9 PPFAC rates. In addition, it provides APS with the ability to reduce its costs, but
10 not Citizens' costs, by running the Valencia units.

11
12 **Q. Please summarize the pricing issue that gave rise to the undercollection**
13 **under the Old Contract.**

14 A. The pricing provisions of the Old Contract were interpreted differently by APS
15 and by Citizens. The Contract contained nominal prices, as well as a minimum
16 price. Until 1999, Citizens had been charged almost entirely on the basis of the
17 nominal prices in the contract, for which the PPFAC provided adequate
18 compensation. The floor (minimum) price was based upon APS' System
19 Incremental Cost ("SIC"). Citizens interpreted the SIC as referring only to
20 market purchases that were made by APS to lower system costs. However,
21 according to APS' interpretation of the contract since 1999, when APS requires
22 purchased power to meet its obligations, the power is purchased in the market and
23 this influences the floor pricing. In other words, to Citizens the SIC should be
24 based on economic purchases and to APS it should be based on reliability
25 purchases. Economic purchases can never be priced higher than the incremental
26 cost of APS' most expensive generating source, whereas there was virtually no
27 upper limit to the price of power purchased for reliability purposes.

28
29 **III. WHY CITIZENS SHOULD HAVE TAKEN ACTION TO MANAGE ITS**
30 **POWER COSTS**

1 **Q. You have testified that Citizens knew it was likely to be exposed to market**
2 **prices, and that it should have anticipated the possibility that market prices**
3 **might increase. What would have been the basis for this knowledge?**

4 A. In the fall of 1999 APS rebilled Citizens for power used during the previous
5 summer, utilizing its reliability definition of the SIC. Citizens protested this
6 definition, but APS did not agree to change its methodology. The combination of
7 two things -- ample evidence that APS would need to purchase power to meet
8 load in the summer of 2000 and a contract interpretation which resulted in
9 Citizens often paying prices based on APS' most expensive purchases -- made
10 future market prices crucial to Citizens power costs. Under these circumstances,
11 managing power costs should have, at a minimum, entailed analysis of future
12 market prices.

13
14 **Q. What did Staff testimony indicate about market prices during the year 2000?**

15 A. My testimony and that of Douglas Smith demonstrated that there were numerous
16 signs in late 1999 and early 2000 that market prices to APS in the summer of
17 2000 were likely to be high. The indicators that suggested this included rising gas
18 prices, low hydro resources, and increasing load throughout the West. Obviously,
19 Citizens could not have known for certain that market prices would be much
20 higher than normal. However, by early spring of 2000, it should have known that
21 there was a reasonable possibility that power costs would be much higher than
22 historic costs. Discovery responses from Citizens make it clear that the Company
23 was aware that fuel prices and supply shortages would influence market prices.

24
25 **Q. Has the Company demonstrated that it should not have known that prices**
26 **might be much higher?**

27 A. No, it has not, even though it introduced in the Rejoinder phase a former
28 California Public Utilities Commissioner, Patricia Eckert, as a new witness to
29 testify on the power market. Ms. Eckert testified that the California electric
30 restructuring plan failed, and that there were no indicators "...well into 2000 that
31 the spikes in power costs would occur in the summer of 2000..." (Rejoinder p. 9-

1 10). She further listed 9 conditions that caused the increase in power costs.
2 These 9 conditions included 6 that were known prior to the summer of 2000,
3 including “Political failures to address the need for bilateral contracts”, “Low
4 hydroelectric production”, “no significant new plants built in California during
5 the prior fifteen years”, “Material increases in California’s population”, “Strict air
6 quality management...”, and “Policy changes to a preference for public power
7 over IOUs”. None of these conditions should have been a surprise to anyone in
8 the power market. Ms. Eckert’s other three conditions include the “hot muggy
9 summer”, “impact of the failed California restructuring plan on the western states
10 power grid”, and the “failure of the WEPX and the CAISO structure.” While the
11 former could obviously not be known, the possibility of a hot summer would have
12 been obvious, as would the impact of a hot summer on load. Ms. Eckert does not
13 mention one other significant cost driver, that is increases in gas prices, for which
14 there were advance indications. In any event, the issue is not whether the high
15 prices could have been foreseen with certainty, but, rather, whether there was a
16 reasonable chance that there would be high prices.

17
18 Mr. Avera also argues that the Company could not have known that prices would
19 be high in the summer of 2000. He opines that markets are driven by differences
20 in forecasts, which he seems to think explains how Mr. Smith “...was able to
21 construct a mosaic of other data that would be suggestive of tightening of power
22 supplies in the West.” (Rejoinder p. 6)

23
24 **Q. Have these Company witnesses demonstrated that Citizens could not have**
25 **anticipated that price increases in the summer of 2000 were likely to be a**
26 **problem?**

27 A. No. Ms. Eckert’s testimony, as that of other Company witnesses¹, is also off
28 point, suggesting that it was acceptable that the Company did not act because it

¹ The Company continues to mischaracterize Staff testimony, as in Mr. Breen’s Rejoinder “Ms. Smith’s statements that Citizens should have expected the high prices that occurred in the summer 2000...” (Rejoinder p.6) My testimony was that Citizens should have anticipated the likelihood that prices would be high.

1 did not know with certainty how bad things would get. The Company did not
2 have to know how high prices eventually became to be concerned. It knew it
3 could be seriously exposed to market prices that were higher than the nominal
4 prices it had been paying. There was ample evidence that there was a reasonable
5 likelihood that prices could increase, and that the increase could be significant.
6

7 While Mr. Avera implies that Mr. Smith referred only to a select few pieces of
8 data, in fact Mr. Smith referred to data regarding most of the major drivers of
9 electric market prices. Mr. Avera does not point to countervailing data that
10 suggested that gas prices were falling, that hydro supplies that were depleted in
11 the spring were likely to become plentiful in the summer, that additional
12 generating supplies would come on line between the spring and summer of 2000,
13 or any other data that might lead to a forecast of flat or falling prices.
14

15 **IV. CITIZENS DID NOT TAKE APPROPRIATE ACTION**
16

17 **Q. You have testified that Citizens knew that APS believed it could charge**
18 **market prices to Citizens, and that Citizens did not effectively address this**
19 **problem. Is this still your opinion?**

20 **A.** Yes. Although Citizens was aware it could be charged market prices for at least
21 some of its load because of the ambiguities in the Old Contract, the only action it
22 took with regard to managing its future power costs, prior to April of 2000, was to
23 attempt to persuade APS that Citizens' interpretation of the ambiguous terms in
24 the contract was correct. Around April 2000, Citizens also attempted to negotiate
25 a new contract.
26

27 **Q. Does the evidence indicate that Citizens fully pursued its disagreements over**
28 **the interpretation of SIC language?**

29 **A.** No. The Company has indicated that prior to the summer of 2000, it never even
30 prepared any estimates of the impact of SIC pricing, even though it knew that
31 SICs might be crucial to its power bills. The "debate" over this issue has existed

1 from when Citizens first was rebilled in the summer of 1999. Citizens did not
2 take the issue to either FERC or the courts, leaving it in the position of continuing
3 to pay bills based on what it believed to be an incorrect interpretation.
4

5 **Q. Has Citizens indicated why it did not pursue litigation regarding the**
6 **interpretation of its contract?**

7 A. Rebuttal testimony by the Company indicates that it believed that such litigation
8 would have a low probability of success. Mr. Flynn's Rejoinder Testimony stated
9 that he ultimately concluded that litigation would not have a high chance of
10 success. However, as this advice was not proffered until the spring of 2001, it
11 provides no additional insight as to why Citizens failed to pursue litigation earlier.
12 (Rejoinder p. 3) Mr. Flynn further stated that he would not advise a company
13 "...to initiate a major contract suit without a good likelihood of success..."
14

15 **Q. If Mr. Flynn had advised that the chances of success were not very high, why**
16 **would the Company still have pursued litigation at FERC?**

17 A. The major reason why such an action would have been justified is that a great
18 many dollars were at stake. Even if the chance of success was judged to be not
19 very high, the returns to Citizens (and its ratepayers) would have been very high
20 in the case of a successful outcome. For instance, if one judged the chance of
21 success to be 50%, there would be a 50% chance of losing the argument and
22 paying the litigation cost, but a 50% chance of being refunded between \$20 and
23 \$70 million. In addition, the major discussions of the SIC interpretation issues by
24 the Company's advisors seems to have been about the limiting of the SIC to
25 economic purchases. There was clearly less analysis and less professional advice
26 regarding the likelihood that Citizens would have been able to persuade FERC
27 that APS' method of assigning the highest cost purchases to Citizens was
28 incorrect. While the possible gains from this argument were not as great, they
29 still appeared to be substantial.
30

31 **Q. Did negotiations regarding the contract have any effect during 2000?**

1 A. The negotiation evidently begun in April resulted in an MOU, dated May 18,
2 2000, but not in an actual revised contract. This document indicated that Citizens
3 and APS intended to develop a new contract that would offer two different prices.
4 This document did not specifically state whether the minimum billing provision
5 would remain or be eliminated. The document further indicated that APS would
6 refund \$1.5 million to Citizens, which was a payment in settlement over a 1999
7 overbilling dispute over \$4.5 million. Citizens' also agreed to withdraw its protest
8 in a then current FERC case on APS' Market Pricing filing.

9
10 **Q. Did this MOU of May 18 reduce Citizens' power costs or cause anything else**
11 **to occur?**

12 A. It did not reduce power costs. Citizens evidently believed that this MOU would
13 eliminate the minimum bills, while APS had a different interpretation of the
14 document. When APS rebilled on the basis of what was purported to be the
15 MOU, it increased rather than decreased bills, particularly since the minimum bill
16 provision was applied. However, Citizens did withdraw its FERC protest before a
17 new contract was signed, a result desired by APS. These are not results one would
18 expect from an effective negotiation effort. At a minimum, Citizens should not
19 have given up anything without a written guarantee of some beneficial change in
20 the contract.

21
22 **V. OTHER SPECIFIC ACTIONS THAT THE COMPANY COULD HAVE**
23 **TAKEN**

24
25 **Q. What did your initial testimony fault the Company for not having done prior**
26 **to the summer of 2000?**

27 A. I criticized the Company for not having taken any actions that might have served
28 to "hedge" its power costs, including pursuit of either a physical hedge or a
29 financial hedge, and planning to run Valencia during high-cost periods.

30

1 **Q. One specific action that you recommended was that the Company should**
2 **have considered a hedge, whereby the Company or APS would purchase a**
3 **block of power at a fixed price as insurance against price increases. What**
4 **was the Company's position about hedging?**

5 A. The Company was aware of hedging, and did not deny that it could have sought a
6 hedge. The reasons it has expressed for not exploring a hedge was that it did not
7 "have some reasonable expectation of significant potential for volatility and
8 spikes in price" and it did not know what the regulatory treatment of such a hedge
9 would have been. Mr. Miller's Rejoinder Testimony added the argument that
10 hedging a large amount of AED's load would have been prohibitively expensive.
11 (Rejoinder p. 6)

12
13 The Company argued that it would have been very risky for it to have purchased a
14 hedge when it did not know what regulatory treatment it would have received.
15 Mr. Dabelstein's Rejoinder provided an additional problem with hedging, in that
16 the Company had no authorization to record hedging costs in the PPFAC bank.
17 (Rejoinder p. 4)

18
19 **Q. Do these arguments justify the failure to hedge?**

20 A. No. With regard to the reason to hedge, Mr. Smith's testimony explained why the
21 Company should have been aware of the real possibility, but not the certainty, that
22 prices in the summer of 2000 might be much higher than they had been. Hedging
23 should have been at least investigated because of this possibility. With regard
24 to the cost of hedging, my testimony demonstrated, based on actual forward prices
25 that were available in the spring of 2000, that hedging part of Citizens' load
26 would not have been prohibitively expensive and would actually have
27 significantly reduced power costs.

28
29 With regard to how a hedge might have been treated, the lack of preapproval to
30 book a hedge in the PPFAC might have increased the risk of regulatory

1 disallowance. On the other hand, however, if this was such a large concern, the
2 Company could have requested approval from the Commission.

3
4 **Q. What could a hedge have accomplished, and how did you address this in**
5 **your initial testimony?**

6 A. I estimated that if Citizens had purchased some forward power for the summer of
7 2000, its power costs could have been reduced by \$14 million. I recommended
8 that Citizens be denied recovery of half of this amount, or \$7 million.

9
10 **Q. Did you suggest that there were other actions that Citizens could have taken**
11 **prior to the summer of 2000 that would have reduced its power costs?**

12 A. Yes. Citizens could have made preparations to use its Valencia peaking units at
13 times when its incremental costs were very high. While the Valencia units are
14 relatively high cost, they were less expensive than peak period market prices in
15 2000 and 2001. If Citizens had run these units during some of the hours when
16 market prices were very high, this action would have reduced the highest cost
17 purchases from APS. Some investment was necessary to run these units in an
18 economic mode, as opposed to only running them for reliability when there was a
19 transmission problem. Given the possibility that Citizens could be subject to high
20 market prices in the summer of 2000, the Company should have made the
21 investments that were necessary to run the units for economics prior to this
22 summer. It also should have been possible to have run the units on a limited basis
23 even before making any modifications to the units.

24
25 **Q. Your testimony portrayed Citizens' problem as a result of the ambiguities in**
26 **the Old Contract, high market prices, and high loads. Has Citizens provided**
27 **any different interpretation of its problem?**

28 A. Yes. In Rebuttal Testimony, Mr. Breen characterized the high summer bills in
29 2000 as "...a result of APS' reversal of its prior commitments in negotiations and
30 its aggressive interpretation of SSA." (p. 24). However, Mr. Breen believes that

1 Citizens couldn't have reasonably anticipated this. Obviously, APS' prior
2 commitments, as described and interpreted by Mr. Breen, were not in writing.

3
4 **Q. Should Citizens have been assured that the "prior commitments" in the**
5 **MOU would solve its problems?**

6 A. If Citizens had asked itself how APS would react if prices increased rapidly, it
7 seems likely that it would have expected that APS would be inclined to protect its
8 own interests before those of Citizens. The minimum billing provision allowed
9 APS to charge Citizens rather than its other customers, for some of its most
10 expensive purchases. It was not in APS' interest to give up the minimum billing
11 provision. The fact that APS did not, on the basis of the MOU, eliminate the
12 minimum billing provision, is clear evidence that depending on the other party's
13 unwritten "word" when so much was at stake was not good strategy. Although
14 Company testimony argues that Citizens could not have foreseen that APS would
15 retain the minimum billing provision after a verbal commitment to remove it, it
16 then attributes APS' behavior to high market prices. The prudent negotiator
17 should have anticipated that high prices might cause APS – in the absence of a
18 written interpretation to the contrary -- to interpret the MOU in a way that would
19 allow it more cost recovery.

20
21 **VI. NEW CONTRACT**

22
23 **Q. How do you recommend that the Commission address under-recoveries due**
24 **to the New Contract?**

25 A. In Direct and Surebuttal Testimony I originally recommended that Citizens be
26 allowed to increase the PPFAC factor to cover the New Contract costs, but also
27 that the Commission further consider the prudence of the New Contract in the
28 Company's next rate case. I now recommend that the PPFAC not be increased to
29 reflect the New Contract until the Commission has more fully investigated issues
30 that reflect on the prudence of signing this contract.

31

1 **Q. What were other parties' positions regarding the contract?**

2 A. RUCO argued that the New Contract was imprudent, as the charges under it were
3 too high, and the PPFAC should not be increased to recover its costs. Mr. Rosen,
4 RUCO's witness, also expressed concern that Citizens' interest in selling the
5 Company conflicted with the interests of AED ratepayers in fully litigating the
6 contract dispute (Surrebuttal Testimony p.8). Mohave County and Mr. Magruder
7 initially did not address the New Contract specifically. In his testimony of
8 September 27, 2002, Mr. Magruder argues that there is no proof that the price in
9 the New Contract is fair and reasonable.

10
11 **Q. Has new information regarding the New Contract increased your concern
12 about prudence in the negotiation of the New Contract?**

13 A. Yes. There are three areas which are of concern and which I believe require
14 further investigation.

15 1) There was a linkage between discussion of the contract and of APS'
16 possible purchase of the AED.

17 2) Both parties were considering three different types of contract, but
18 Citizens subsequently limited the discussion to only a long-term fixed rate
19 contract.

20 3) The manner in which Citizens negotiated the contract and analyzed its
21 options is problematic.

22
23 **Q. What are the indications of a linkage between the two topics, a new contract
24 and the sale of the AED?**

25 A. A draft of a memo to Dan McCarthy of Citizens (Data Response to Counties,
26 BB000307)² indicates that discussions between APS and Citizens during May
27 2001 were expected to address both topics. This memo refers to an agreement
28 resulting from a May 3, 2001 meeting between Pinnacle West and Citizens, "...in
29 an effort to settle and resolve any and all outstanding disputes, to undertake
30 further settlement discussions with respect to (a) the potential acquisition by

² This and other cited portions of data responses are contained in Attachment S-3.

1 Pinnacle West of Citizens' Arizona electric operations, and (b) the potential
2 restructuring of the Power Service Agreements..." This particular memo was
3 apparently drafted between May 3 and May 15, when an attached cover sheet
4 from Russ Mitten was dated. A handwritten document from the response to Staff
5 Data Request 15.01, CCC006475, also appears to link the contract and sale of
6 AED discussions. Although its precise meaning is ambiguous, I include it here
7 for the sake of completeness. The document says:

8 " Solution - 2 path

9 __ Restr. Contract---Skin for both sides

10 __ Looking @ buying whole thing."

11 In my opinion, these pieces of information clearly raise the possibility that the
12 sale of the AED may have been tied to discussion of the power supply contract.

13
14 **Q. Why is this linkage a concern?**

15 A. The Company's interest in selling the utility may have affected its negotiations for
16 a new contract. Citizens has clearly been very eager to sell its utility holdings,
17 and a potential sale to Cap Rock had collapsed in March. Moreover, one
18 incentive to agreeing to high power prices -- the possible impact on the sale price
19 of the AED -- may have been removed if the purchaser and the power supplier
20 were the same entity. The apparent conflict of interest would have continued
21 throughout discussions of the revised Power Supply contract that was signed on
22 July 16, 2001. If Citizens had held out for a more favorable contract, such a
23 strategy might have affected APS' interest in acquiring the AED. The available
24 evidence may not allow for a firm conclusion regarding the contract-sale linkage,
25 but the Commission should further explore it.

26
27 **Q. Do you have any other concerns about the New Contract that have been**
28 **informed by further discovery responses?**

29 A. Yes. In my original testimony, I expressed concern about Citizens' evident lack
30 of analysis of the fixed price contract. Further discovery has exacerbated rather

1 than alleviated my concern. For instance, a number of contract options had been
2 possible but Citizens elected to pursue only the fixed price option.

3
4 **Q. What options other than a new fixed price contract did Citizens have?**

5 A. As stated in my original testimony, remaining with the existing contract might
6 have been a viable option if future market prices were expected to fall. Acquiring
7 a hedge against future price variability might have been an option. Canceling
8 Schedules B and C of the existing contract and replacing them with other
9 contracts would have been possible. Utilizing the Valencia units, in combination
10 with any of the other options described above, would have reduced Citizen's
11 exposure to peak period market prices. According to discovery responses,
12 Citizens never performed analyses of these options.

13
14 The new contract with APS did not have to take the form of a fixed price contract
15 but could have taken various forms. New discovery responses indicate that
16 alternative forms had been considered. According to a letter to APS on
17 November 22, 2000, the contract options which APS and Citizens were
18 considering included 1) a fixed price contract, 2) the joint development of a
19 separate portfolio to service Citizens' load, and 3) the development of a portfolio
20 of purchases from specific generating units, which could be dispatched by
21 Citizens. In November and December of 2000 Citizens was considering various
22 terms for a possible new contract with APS.

23
24 **Q. Has Citizens indicated why it eliminated consideration of all but the fixed
25 price option for a new contract?**

26 A. Yes. On May 11, 2001, a handwritten note describes an APS proposal with three
27 different options, indicating that APS was willing to offer different options.
28 According to the response to Staff Data Request 15.08, Citizens did not pursue
29 the second and third options as Citizens itself "...focused these discussions [on a
30 new contract] on a fixed-price option because it believed, based on the

1 information available at the time, that such an option would be in the best interest
2 of its customers.”

3
4 **Q. What was Citizens’ definition of the best interests of its customers?**

5 A. According to the response to Staff Data Request 16.09, Citizens considered the
6 attributes of a power supply with the attributes of “adequacy, reliability, cost, and
7 cost stability”, in that order of priority, to be in the best interest of its customers.

8
9 Further, the response to Staff 15.12 indicates that Citizens’ desire to shield
10 customers from future price volatility was the reason that it dropped consideration
11 of any contract alternatives other than the full service fixed price option.

12
13 **Q. Did the Company compare and analyze cost impact versus the cost stability
14 impact of the three types of contracts?**

15 A. Evidently, the Company’s decision to only work toward a fixed price contract was
16 not informed by an analysis of the cost and cost stability of all the options.
17 According to the response to Staff 15.11, which asked for analyses of other power
18 contract options, “Discussion of alternative contract options did not develop to the
19 level where analyses were undertaken.” The discovery response to Staff Data
20 Request 16.11 indicates that the Company expected that it would be difficult to
21 assemble a portfolio of unit contracts that contained fuel diversity, and that the
22 alternative, a portfolio that was primarily gas-fired units, would have exposed
23 customers to “relatively high price volatility.”

24
25 **Q. Does this seem to you to provide adequate justification to reject contracts
26 that were based on a portfolio of contracts or units?**

27 A. No. While such contracts would have more volatility than a fixed price contract,
28 lower cost or other benefits might have made this a reasonable tradeoff. I would
29 have expected that the Company would have analyzed at least two broad issues.
30 The primary one would be how the expected cost of such a portfolio compared to
31 the cost of the fixed price contract. The second would be the relative magnitude

1 of price volatility of the gas-based portfolio as compared to the volatility resulting
2 from the existing contract. It might be worth accepting some increase in volatility
3 in order to reduce expected costs significantly.
4

5 **Q. Was a fixed price contract the only means of shielding customers from the**
6 **volatility of market prices?**

7 A. No. Although a fixed price contract would produce total "cost stability", the other
8 options that Citizens was considering in December of 2000 could have also
9 reduced the level of price variability from what Citizens had experienced under
10 SIC pricing with no hedging and no Valencia economic production. Even if the
11 contracts were primarily gas, prices would vary primarily with the cost of the fuel
12 utilized by the units. Market prices had varied not only with gas prices but also
13 because of supply shortfalls, because of hot weather, because of low hydro levels,
14 and because of problems in the market. Price increases in 2000, and price
15 volatility, due only to changes in gas prices, would have been much less than the
16 actual variability in market prices. Moreover, any portfolio could have been at
17 least partially hedged. Thus the rejected power contracts options could have
18 eliminated some price variability.
19

20 **Q. Having determined to pursue only a fixed price contract, how did the**
21 **negotiation process continue?**

22 A. Negotiations proceeded quickly. It is not clear how the price in the contract was
23 arrived at. In response to the question in Staff Data Request 16.13, "...did APS
24 originally propose the price of \$58.79/MWH...", the Company stated that
25 "...discussions between Citizens and Pinnacle West produced two alternative
26 proposals, the proposal that was originally selected...and a proposed ten-year
27 contract at a slightly lower rate..." We know from earlier discovery that the
28 Company did not analyze the economics of the New Contract, other than a
29 comparison of the fixed price terms to prices in May of 2001.
30

- 1 **Q. Does this suggest that there was any actual negotiation about price between**
2 **APS and Citizens?**
- 3 A. This is not clear. The "discussions" may have involved some back and forth, but
4 the question specifically asked whether this price was the one originally offered
5 by APS, and the response does not indicate whether this was in fact the case.
6
- 7 **Q. How would you have advised a client to approach such a contract offer?**
- 8 A. I would advise a client to compare any fixed price offer to expected market prices
9 over the term of the contract. A fixed price might be less than current market
10 prices but considerably higher than expected future market prices. Since APS
11 needed additional capacity in order to meet Citizens' load, any price offered by it
12 should be based either on market prices or on a combination of its own resources
13 plus resources purchased from the market. The client should also determine how
14 much it was willing to pay for price stability.
15
- 16 **Q. Can you conclude from this lack of analysis that signing the New Contract**
17 **was imprudent?**
- 18 A. No. What is clear, in my opinion, is that the approach taken by Citizens to
19 contractual matters, including the negotiation of the new agreement, was
20 inadequate. What we do not know, in the absence of the requisite analyses by
21 the Company, is the impact of the contract on ratepayers and whether the New
22 Contract's terms are likely to produce lower ratepayer benefits than other
23 alternatives that would have been available. I deliberately have said "lower
24 ratepayer benefits" rather than higher ratepayer costs, because a reduction in price
25 volatility and a reduction of risk do have some positive value. However, without
26 evidence of appropriate analyses, we cannot conclude anything at this point about
27 the New Contract's relative value. In other words, what we do not know is
28 whether, despite its inadequate approach to the contracting process, this contract
29 may be a reasonable outcome. In my opinion, this is a matter that should be
30 explored by the Commission.
31

1 **Q. How would it be possible after the fact to assess the New Contract?**

2 A. One would perform an analysis to estimate whether the fixed price produced costs
3 over the life of the contract that were higher or lower than the expected costs that
4 would have resulted from the Company's other options, such as remaining with
5 the Old Contract, while utilizing the Valencia units to reduce peak costs. Such an
6 analysis obviously should be based on information that was available in July
7 2001. By expected costs, I mean that the analysis should consider more than one
8 set of possibilities for major cost drivers. It might be deemed acceptable, for
9 example, for the contract to produce costs that were somewhat higher than
10 expected costs under other options, but this conclusion would be based on placing
11 a positive value on the reduction of price volatility. In addition, whether other
12 contract options might have produced still better results should be explored.
13

14 **VII. RECOMMENDATIONS**

15
16 **Q. In your original testimony, you recommended that Citizens be required to**
17 **defer collection of \$49 million, representing the amount that Citizens**
18 **believed it had been overbilled through December of 2000. Do you now have**
19 **updated values that should be used?**

20 A. Yes, they should be updated. The response to RUCO 6.3 established that Citizens
21 believed it had been overbilled through May of 2001 by \$70.4 million. The total
22 disputed amount of \$70.4 million should be deferred for collection until this issue
23 has been pursued. The total undercollection increases every month, since costs
24 under the New Contract are higher than the current power costs in rates and in the
25 PPFAC, and since the Company is accruing interest on the undercollection. This
26 results in my recommendation that the Commission should allow Citizens to
27 begin collecting \$87.7 million less the denial of \$7 million, less the disputed
28 \$70.4 million, or \$10.3 million. Collection of some, all, or none of the \$70.4
29 million should depend on resolution at FERC or in the courts of the dispute over
30 SIC interpretation. Since the amount that I am currently recommending be

1 allowed is smaller than the amount originally recommended, it can be collected
2 over a shorter period without having a larger impact on customers.

3
4 **VIII. IMPACT OF DENIAL AND DEFERRAL OF RECOVERY**

5
6 **Q. What was the Company's position with regards to your original
7 recommendations regarding recovery?**

8 **A.** Mr. Dabelstein argues that the denial of carrying costs on the recoverable balance
9 is conceptually inconsistent with the accrual of carrying charges that was
10 supported by Ms. Smith in regard to the stranded cost settlement. Mr. Avera
11 argues that this would result in reducing Citizens' coverage ratio to a level that
12 would not maintain Citizens' financial integrity or allow it to attract capital on
13 reasonable terms. Mr. Avera also argues that the ACC's prior treatment of the
14 AED has always been as a stand-alone, low risk utility.

15
16 **Q. Do any of these arguments change your recommendations?**

17 **A.** No. The stranded cost settlement addressed power costs that the Company
18 incurred but could not collect immediately, and the Company would have had no
19 responsibility for customer choice. In this case, the Company does bear some
20 responsibility for the situation that it is in. One of the major points of my
21 testimony is that not all of the power costs incurred under the Old Contract were
22 reasonable, since they could have been reduced through prudent actions on the
23 part of Citizens, and the disputed amount is not necessary until it has been
24 determined by either FERC or a court that it was all necessary. We do not have
25 adequate evidence to judge the reasonableness of power costs under the New
26 Contract.

27
28 With regard to Citizens' ability to attract capital, Mr. Avera does not argue that
29 Citizens could not finance the recommended disallowance and deferral, but only
30 that it is not fair that the parent Company be required to do so. However, the
31 parent company has ultimate responsibility for providing the AED with the

1 resources necessary to address its problems. While Mr. Avera denies that
2 Citizens has been in any way at fault, his argument would suggest that ratepayers
3 should fully compensate the Company even if the Company was at fault. I do not
4 believe that Citizens, or any regulated utility, should be insulated from penalties
5 for poor management because of its poor financial condition.

6
7 **Q. Does this conclude your testimony?**

8 **A. Yes.**

Attachment S-3

May __, 2001

Mr. Dan McCarthy
Citizens Communications Company
1300 S. Yale Street
Flagstaff, AZ 86001

Re: Settlement Discussions between Arizona Public Service Company
("APS")/Pinnacle West Capital Corporation (collectively "Pinnacle West") and
Citizens Communications Company ("Citizens")

Dear Dan:

This letter is sent as a follow up to our recent discussions and the meetings between Pinnacle West and Citizens relating to various issues involving our two companies.

This letter will confirm that Pinnacle West and Citizens met on May 3, 2001 to address a series of issues, including issues arising out of disagreements in the interpretation of the Power Service Agreement between Citizens and APS. The above meeting resulted in an agreement between Pinnacle West and Citizens, in an effort to settle and resolve any and all outstanding disputes, to undertake further settlement discussions with respect to (a) the potential acquisition by Pinnacle West of Citizens' Arizona electric operations, and (b) the potential restructuring of the Power Service Agreements, and the various addendum's and amendments thereto (hereafter collectively the "Settlement Issues"). The above-referenced discussions as to the Settlement Issues commenced with the May 3, 2001 meeting and are projected to continue through the end of May (the foregoing time period will be referenced herein as the "Due Diligence Period").

In order to undertake the necessary review and analysis during the Due Diligence Period and more fully evaluate each party's level of interest and/or participation in the Settlement Issues, Pinnacle West and Citizens desire to obtain access to additional information from one another. To facilitate the openness and exchange of such necessary information, the parties agree and acknowledge that all discussions relating to the Settlement Issues during the Due Diligence Period, including the May 3, 2001 meeting, are intended to be confidential and used for settlement purposes only as to the disputes and disagreements by and between Pinnacle West and Citizens.

In this regard, any and all discussions, along with any information or documentation exchanged between the parties, during the Due Diligence Period relating to the Settlement Issues, is agreed by the parties to be for confidential settlement purposes only and subject to Rule 408 of the Federal Rules of Evidence and any corresponding or related state or administrative

BB000307

Mr. Dan McCarthy

May 8, 2001

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rules of evidence and/or procedure. This limitation is also expressly intended to include restrictions on the use and/or discussion of any such information and/or documents in any proceedings of any kind before the Federal Energy Regulatory Commission or the Arizona Corporation Commission. Similarly, nothing in our discussions as to the Settlement Issues is intended to affect or limit any defense or claim available to any party or to operate as an admission or concession on the part of any party. Instead, we view these discussions as an opportunity for the parties to cooperate openly with each other with the mutual goal of resolving our differences if possible.

Pinnacle West and Citizens agree that (1) no joint venture, partnership or other fiduciary relationship shall be deemed to exist or arise with respect to the Settlement Issues except as expressly described herein or otherwise specifically agreed to in writing executed by both parties, and (2) neither party shall have any obligation to participate in any manner in the Settlement Issues except as expressly described herein or otherwise specifically agreed to in writing executed by both parties. In addition, both Pinnacle West and Citizens represent that nothing contained herein violates any obligation to any third party, and that all costs and expenses incurred in connection with the due diligence relating to the Settlement Issues shall be borne by the party incurring such costs and expenses.

We look forward to working with you during the Due Diligence Period.

Sincerely,

AGREED AND ACKNOWLEDGED:

CITIZENS COMMUNICATIONS

By: _____

Title: _____

APS mtg. - VERY WELL
A-TEAM - I HEAD UP

2 WEEKS INTENSIVE WORK

IN PHX

EVERYTHING ON TABLE
DEAL TO SOLVE EVERYTHING
PROSPECTIVELY & RETROSPECTIVELY
MITIGATE PROBLEM GOING FORWARD

Call
Immune

Working &
Spreadsheets

DELAIS
JOE

ALIT GELBER

~~CRANK~~

PEOPLE WHO CAN CRANK MODELS.
SOLUTION - 2-PATH

- RESTR. CONTRACT - SKIN FOR BOTH
SIDES.

- LOOKING @ BUYING WHOLE THING.

St Henry
Friday 2nd Week
Steve Sherman

ON LITIGATION

Dave Morgan - Yes, howie far

Dave Label
Paul McGuire

**Citizens Communications
Docket No. E-01032C-00-0751
Arizona Corporation Commission's Fifteenth Set of Data Requests**

Witness: Sean Breen

Data Request No. LS 15.08:

Did Citizens decide not to pursue any option other than the fixed price option, or were there discussions of other options after December 6, 2000?

Response:

Citizens did not exclude any particular option at the time of the late 2000 contract discussions. Citizens' decision to increase its focus on possible legal actions against APS was made shortly after the discussions about potential contract alternatives began. Consequently, no further discussions between the parties on restructuring the power supply contract occurred for several months. Negotiations that ultimately led to the new APS/PWCC contract began in May 2001. While initial discussions for the new contract included consideration of alternatives, Citizens focused these discussions on a fixed-price option because it believed, based on the information available at the time, that such an option would be in the best interest of its customers.

**Citizens Communications
Docket No. E-01032C-00-0751
Arizona Corporation Commission's Fifteenth Set of Data Requests**

Witness: Sean Breen

Data Request No. LS 15.09:

If there were any discussions, analyses, exchange of Emails or other correspondence regarding power purchase options other than a fixed price contract after December 6, 2000, please indicate what the forum for the discussions were, and who were the participants in these discussions.

Response:

Please see the response to Staff Data Request No. LAJ 4.02 for a chronology, description and list of participants of contract discussions.

Citizens Communications
Docket No. E-01032C-00-0751
Arizona Corporation Commission's Fifteenth Set of Data Requests

Witness: Sean Breen

Data Request No. LS 15.12:

If the answer to 15.04 was that Citizens itself decided not to attempt to negotiate any contract other than a fixed price contract, please indicate the justification for that decision, including any workpapers, notes, or analyses that impacted this decision by Citizens.

Response:

It is assumed that this question refers to Staff Data Request No. LS 15.08. Citizens focused its efforts on a fixed-price approach because it believed that the demonstrated volatility of the electric markets experienced in 2000 and 2001, which Citizens was concerned would continue into the summer 2001, strongly suggested the favorability of a fixed-price contract that would shield customers from future volatility.

**Citizens Communications
Docket No. E-01032C-00-0751
Arizona Corporation Commission's Fifteenth Set of Data Requests**

Witness: Sean Breen

Data Request No. LS 15.11:

Please provide any written material not otherwise provided containing any analyses of power contract options other than the fixed price option.

Response:

Please see the response to Staff Data Request No. LS 15.07. Discussions of alternative contract options did not develop to the level where analyses were undertaken.

**Citizens Communications
Docket No. E-01032C-00-0751
Arizona Corporation Commission's Sixteenth Set Of Data Requests**

Witness: Sean Breen

Data Request No. 16.11:

Did the Company believe that a contract based on a portfolio of unit contracts would leave customers exposed to as much price volatility as the Old Contract had?

Response:

This question is difficult to answer in the abstract without having more particulars for comparison. While in theory one could define a portfolio of unit contracts with a diverse fuel mix and lower expectation of price volatility, it was not clear at the time that such a portfolio could in fact be assembled, particularly in view of the fact that the preponderance of new generation in the West was based on natural gas fuel. Citizens believed that a contract alternative based heavily on natural-gas fueled units would expose customers to relatively high price volatility.

**Citizens Communications
Docket No. E-01032C-00-0751
Arizona Corporation Commission's Sixteenth Set Of Data Requests**

Witness: Sean Breen

Data Request No. 16.13:

With regard to the New Contract, did APS originally propose the price of \$58.79/MWH, or did it request a different price? If it first requested a different price, what was that price? Please describe the negotiations between the two parties over price or terms of the contract. Provide all memos, notes, analyses, or other written documentation of price offers made by either party, with dates, during the period from March 2001 until the contract was signed.

Response:

The discussions between Citizens and Pinnacle West produced two alternative proposals: the proposal that was originally selected (a seven-year contract at a price of \$58.79/MWH) and a proposed ten-year contract at a slightly lower rate than that quoted for the seven-year deal. No one at Citizens who was involved in the discussions can recall the price that was offered for the ten-year contract, and a diligent search of the company's records produced no memos, notes, analyses, or other documents regarding the ten-year proposal made by Pinnacle West.