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BEFORE THE ARIZONA CORPORATION COMMISSION

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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 THE ENERGY RISK MANAGEMENT INITIATIVES.	DOCKET NO. E-01032C-00-0751
IN THE MATTER OF THE APPLICATION OF CITIZENS COMMUNICATIONS COMPANY, ARIZONA GAS DIVISION, FOR A HEARING TO DETERMINE THE FAIR VALUE OF ITS PROPERTIES FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, AND TO APPROVE RATE SCHEDULES DESIGNED TO PROVIDE SUCH A RATE OF RETURN.	DOCKET NO. G-01032A-02-0598
IN THE MATTER OF THE JOINT APPLICATION OF CITIZENS COMMUNICATIONS COMPANY AND UNISOURCE ENERGY CORPORATION FOR THE APPROVAL OF THE SALE OF CERTAIN ELECTRIC UTILITY AND GAS UTILITY ASSETS IN ARIZONA, THE TRANSFER OF CERTAIN CERTIFICATES OF CONVENIENCE AND NECESSITY FROM CITIZENS COMMUNICATIONS COMPANY TO UNISOURCE ENERGY CORPORATION, THE APPROVAL OF THE FINANCING FOR THE TRANSACTIONS AND OTHER RELATED MATTERS.	DOCKET NOS. E-01933A-02-0914 E-01932C-02-0914 E-01932A-02-0914

Arizona Corporation Commission
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AUIA'S POST-HEARING BRIEF

Pursuant to the Procedural Order dated February 7, 2003, the Arizona Utility Investors Association (AUIA) hereby submits its post-hearing brief in the above-captioned matter.

1. Introduction

UniSource Energy Corporation has agreed to buy the Arizona gas and electric properties of Citizens Communications Company for $230 million, a price that reflects a massive discount from book value.

It is difficult to imagine a transaction that could be more in the public interest. It provides more than $150 million of direct and immediate consumer benefits, $135 million in long term rate base reductions and a moratorium on rate increases for at least three years for Citizens' gas and electric customers.

The buyer is a well-known and highly qualified Arizona company. Its chief operating subsidiary, Tucson Electric Power (TEP), is a certificated electric service provider that is regulated by this Commission. No party to this proceeding has suggested that UniSource is not a fit and proper entity to acquire and operate Citizens' assets.

However, it remains for the Commission to determine whether the terms and conditions of the acquisition are consistent with the public interest. In this case, the Joint Applicants (Applicants) modified the terms in a negotiated Settlement Agreement with the Staff of the Commission.

It should be noted that among four intervenors who registered objections to the proposed Agreement, only one, Marshall Magruder, created an evidentiary record through sworn testimony. The hearing in this matter tended toward a repetitive examination of the fundamentals of the Agreement and the reasoning of the signatories rather than a vigorous challenge to it.

Testimony on the Settlement Agreement focused on four basic elements: a) the basic provisions of the UniSource acquisition; b) the financing plan; c) the impact on electric rates; and d) the impact on gas rates.

2. The Purchase Agreement and Rate Base

Under the terms of the Settlement Agreement, UniSource's $230 million purchase of Citizens' assets produces a $124.5 million reduction in Citizens' book value for ratemaking purposes, $93.8 million in electric rate base and $30.7 in gas rate base.[1] Staff described these discounts as negative acquisition adjustments that would result in permanent reductions in rate base.[2]

In addition, the Agreement reflects that UniSource has also consented to a $10 million disallowance to the Commission-mandated gas build out program, which produced an additional permanent write-down of the rate bas and resulted in a reduced revenue requirement in the gas rate case.[3]

Another major element of the Agreement is UniSource's commitment to forego any collection of Citizens' purchased power and fuel adjustment clause (PPFAC) bank balance through the proposed closing date of July 28, 2003.[4] UniSource witness James Pignatelli estimated that the uncollected balance could reach nearly $138 million by that date.[5]

Staff witness Lee Smith confirmed that the uncollected amount includes about $70 million that was disputed by Citizens under its wholesale purchase contract with Arizona Public Service Co. (APS) that was in effect prior to June 2001, and about $50 million results from higher costs under its current contract that Citizens has not been authorized to collect from ratepayers.[6]

Ms. Smith testified that without the Settlement Agreement, Citizens' ratepayers would be at risk for paying both of these amounts under a worst case scenario and that even a best case scenario would produce a ratepayer liability of about $40 million[7] that UniSource would absorb under the Agreement.

Citizens' witness Daniel McCarthy testified that if the UniSource acquisition fails and Citizens remains the owner of the electric system, the company would pursue its PPFAC claims "aggressively."[8]

Mr. Magruder argued in his pre-filed testimony that the Settlement Agreement should not be acted upon until there is some official resolution of the

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[1] See Exhibit JA-6, Appendix B
[2] See Exhibit S-1, P. 4, 6
[3] See Exhibit S-1, P. 6-7 and JA-6, P. 4
[4] See Exhibit JA-6, P. 3
[5] See Exhibit JA-1, P. 11
[6] See Exhibit S-1, P. 36 and Tr. P. 323-324
[7] See Exhibit S-1, P. 37 and Tr. P. 297
[8] See Tr. P. 467

PPFAC amount formerly disputed by APS and Citizens.[9] However, witnesses for Staff and UniSource responded that UniSource's agreement to forego collection of the entire PPFAC balance makes the previous dispute moot.[10]

3. The Financing Plan

According to the Settlement Agreement, UniSource expects to purchase the Citizens assets through one or more subsidiary companies, separating the transaction from TEP and its ratepayers.[11] UniSource witness Kevin Larson said the purchase will include a combination of debt and equity, but the goal is to achieve an investment grade credit rating for the new companies. He said that could occur within a range of debt-to-equity ratios with an approximate midpoint of 40 percent equity to 60 percent debt.[12]

Debt instruments could include up to $250 million in bridge financing, up to $175 million in long-term debt and a short-term revolving credit facility of $50 million.[13] To aid UniSource in providing an equity infusion in the new companies, if it becomes necessary, the Agreement provides that UniSource may borrow up to $50 million from TEP.[14] Under the Agreement, UniSource would pay an interest premium to TEP that would be used to reduce TEP rates by as much as $6 million.[15] In addition, TEP ratepayers would be insulated from any credit repercussions resulting from the loan.[16]

If the loan provision were exercised, it would be secured by an equity interest in the Citizens assets.[17] At hearing, Commissioner Gleason expressed concern that if the credit provisions are additive, they could create a scenario in which the TEP loan would be secured by less than $50 million in remaining equity.[18] Mr. Larson responded that the credit options are not additive and that

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[9] See Exhibit Magruder-2, P. 13
[10] See Tr. P. 159, 428
[11] See Exhibit JA-6, P. 7-8
[12] See Exhibit JA-7, P. 8
[13] See Exhibit JA-6, Appendix A
[14] See Exhibit JA-6, P. 10
[15] See Exhibit JA-6, P. 11
[16] Ibid.
[17] See Exhibit JA-6, P. 10-11
[18] See Tr. P. 265, 267

all of the debt instruments could not be in place at the same time.[19] However, Commissioner Gleason did not appear to be convinced.

When Staff witness John Thornton took the stand, he reiterated that the loan provisions are not additive,[20] rendering Commissioner Gleason's scenario implausible. AUIA would add that if Commissioner Gleason's scenario were plausible, the rating agencies would recoil from the transaction and the goal of an investment grade credit rating would be defeated, to the detriment of UniSource.

In this context, it should be noted that the new companies are restricted by the Settlement Agreement from sending up any more than 75 percent of their earnings to the parent unless their equity ratio is at least 40 percent.[21] This acts as an additional brake against excessive debt capitalization.

4. The impact on Electric Rates

The largest single benefit in the Settlement Agreement is UniSource's forgiveness of the PPFAC bank balance accumulated through next July 28, which is expected to reach nearly $138 million by that date.[22] Staff witnesses Linda Jaress and Lee Smith confirmed that recovery of the PPFAC balance would expose consumers to a rate increase of 40 to 45 percent, compared with about 22 percent under the Settlement Agreement.[23]

The proposed increase stems entirely from the cost of purchased power going forward and consists of three elements: a) the cost of the long term contract with Pinnacle West Capital Corporation that became effective in June 2001; b) transmission charges from the Western Area Power Administration; and c) line losses.[24]

The difference in unit cost between what Citizens is authorized to collect from ratepayers and the current cost at the meter is 1.825 cents per kWh[25]

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[19] See Tr., P. 266-267
[20] See Tr., P. 442-444
[21] See Exhibit JA-6, P. 12
[22] See Exhibit S-1, P. 2
[23] See Exhibit S-1, P. 40-41 and Tr., P. 327-328
[24] See Exhibit JA-6, P. 15 and JA-6, Appendix C
[25] See Exhibit JA-4, P. 13 and S-1, P. 32

and the Settlement Agreement asks the Commission to approve recovery of this differential.

Implicit in this request is UniSource's intent to honor the Pinnacle West contract through the end of its term. However, UniSource has pledged to use its best efforts to negotiate with Pinnacle West for a lower cost and the Agreement calls for the company to pass on to ratepayers 60 percent of any savings.[26]

Both the cost of the Pinnacle West contract and the proposed savings split were challenged by some intervenors.

Mr. Magruder asserted in testimony that the Pinnacle West contract is over-priced in today's market and he cited examples of spot market indexes that show prices below the Pinnacle West contract cost of 5.879 cents per kWh.[27] Mr. Magruder and other intervenors also suggested that the contract amount might have been unduly influenced by alleged manipulation of the California market in 2001.[28]

UniSource witness Michael DeConcini responded that he had conducted an analysis of the Pinnacle West contract, both in the context of the time at which it was negotiated and in comparison with current market conditions.[29]

He asserted that the Pinnacle West contract compared favorably to other long-term contracts that were negotiated in western markets in 2001, which showed costs ranging from 6 cents to 16.5 cents per kWh.[30] He also said he is aware of no evidence suggesting that the contract was influenced by market manipulation.[31]

Mr. DeConcini testified that UniSource modeled the cost of a unit-specific, resource-based alternative and also conducted a market-based analysis to compare the forward cost of the Pinnacle West contract. The comparable prices developed in these analyses were 6 cents and 8 cents per kWh, respectively, leading to the conclusion that the Pinnacle West contract is not overpriced

[26] See Exhibit JA-6, P. 15
[27] See Exhibit Magruder-2, P. 19-20 and S-1, P. 35
[28] See Tr., P. 193
[29] See Exhibit JA-9, P. 4-5
[30] See Exhibit JA-9, P. 4
[31] See Tr., P. 193-198

today.[32] He asserted that spot market prices, like those cited by Mr. Magruder, do not provide a valid comparison with the competitive cost of a long-term, fixed price, full requirements contract like the Pinnacle West agreement.[33]

In short, Mr. DeConcini's conclusion was that the contract was prudent when it was negotiated in 2001 and that it is prudent in today's wholesale market.[34]

Although generally supportive of the Settlement Agreement,[35] RUCO objected to the size of the company's share of any savings that might accrue from further negotiations with Pinnacle West. RUCO calculated that a 10 percent saving on the Pinnacle West contract would result in a $3 million windfall for the UniSource electric subsidiary, based on a 40 percent share. RUCO recommended reducing the company's share to 10 percent.[36]

Staff offered two responses. Ms. Jaress noted that the original joint application called for a 50-50 split and that the 40-60 split in the Agreement was simply a negotiated result that reflected the company's desire for an appropriate incentive.[37] Second, Ms. Smith asserted that RUCO's savings expectations were overstated by about 500 percent.[38]

UniSource witness Steven Glaser responded that the proposed split was appropriate to compensate UniSource for the time and cost that would be expended on renegotiation.[39]

Finally, RUCO proposed a significant increase in the level of demand side management (DSM) programs as a way to mitigate the rate impact.[40] RUCO recommended that Citizens' annual DSM outlay of $175,000 be increased to a minimum of $450,000 and as much as $1 million, depending on the outcome of the Pinnacle West contract negotiations.[41]

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[32] See Exhibit JA-6, P. 5-6, Tr. P. 235
[33] See Tr. P. 160-161
[34] See Tr., P. 165
[35] See Exhibit RUCO-1, P. 2
[36] See Exhibit RUCO-1, P. 9-10
[37] See Tr., P. 348-349
[38] See Tr., P. 332-333
[39] See Tr. P. 191
[40] See Exhibit RUCO-1, P. 9
[41] See Exhibit RUCO-1, Appendix II

Mr. Glaser testified that UniSource would be willing to re-examine its DSM commitment, but asserted that this is not the appropriate time to initiate such an increase. He noted that the Commission's recent policy has been to shift funds from DSM to renewable energy resources and that forthcoming workshops on DSM may lead to new Commission policies.[42]

5. The Impact on Gas Rates

Because the electric rate increase is a pure pass-through of wholesale costs, the only new revenues to support this transaction emanate from the gas rate case. It should also be noted that UniSource has committed in the Agreement to refrain from filing either an electric or gas rate case for three years.

As both Mr. Glaser and the Staff Report asserted, Citizens' rate filing sought a revenue increase of $21 million. Most of the proposed increase was attributable to a massive gas service build out that was ordered by the Commission in Citizens' 1993 rate case.[43]

The Joint Application reduced the revenue requirement to $16,6 million[44] and the Settlement Agreement reduces it further, to $15.2 million.[45] Altogether, the requested increase has been lowered from 28 percent to 21 percent, a difference of $5.8 million.[46]

Staff believes that this result is another element that contributes to a finding that the Agreement is in the public interest.[47] Staff witness James Dittmore testified that Citizens could reasonably have expected to obtain more rate relief than the settlement amount,[48]

Both Mr. Glaser and Mr. Larson testified that in terms of cash flow to support the acquisition, the revenue stream resulting from the Settlement Agreement is as tight as the transaction can withstand.[49]

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[42] See Exhibit JA-5, P 3, 4-6
[43] See Exhibit S-1, P. 14
[44] See Exhibit S-1, P. 22
[45] See Exhibit S-1, P. 6
[46] Ibid.
[47] See Exhibit S-1, P. 3
[48] See Tr., P. 294, S-1, P. 22
[49] See Tr., P. 157-158

Mr. McCarthy of Citizens testified that if the transaction were to fail, Citizens would battle for the revenue requirement in its original filing.[50] Mr. Dittmore testified that because the Commission mandated the build out program, the final outcome of a fully litigated rate case could be unpredictable and would expose ratepayers to greater risk.[51]

In addition to the reduced revenue requirement, Staff points to a $10 million reduction in gas rate base that was negotiated into the Settlement Agreement.[52] Staff asserts that this permanent write-off not only contributed to the lower revenue requirement in this case, but will benefit ratepayers in future rate cases.[53] Staff offers the write-down as additional evidence that the Agreement serves the public interest.[54]

Mr. McCarthy testified that if the transaction were derailed, Citizens would not voluntarily reduce its gas rate base by $10 million.[55]

6. Conclusion

It is absolutely clear from the evidence in this proceeding that the electric and gas customers of Citizens Communications Co. will be far better off with UniSource acquisition than without it. For the ratepayer, there is no better deal out there than the UniSource offer and it is not likely that there will be.

If the Settlement Agreement is not approved and the UniSource acquisition fails, the ratepayers will face these consequences:

- They will lose the current and future benefits of at least $135 million in reductions to rate base. At 11 percent return on equity, that represents an annual revenue requirement of nearly $15 million that will never appear in rates.
- They will risk having to pay all or some of $138 million in accumulated purchased power costs that UniSource and Citizens will forego under the Agreement. That translates into a potential rate increase of 27 to 40 percent.
- They will risk having to pay for all of Citizens' gas build out program, which could result in a rate increase approaching 28 percent.

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[50] See Tr., P. 467
[51] See Tr., P. 291-292
[52] See Exhibit S-1, P. 6
[53] See Exhibit S-1, P. 7
[54] See Exhibit S-1, P. 3
[55] See Tr., P. 467-468

• They will lose the opportunity to obtain reduced electric costs through a renegotiated wholesale contract.

• Last but not necessarily least, they will lose the chance to be served by a company that wants their business rather than a company that does not.

The price for capturing these benefits is to accept modest rate increases for gas and electric service right now. Rate increases are never appealing, especially when they are in double digits, but these increases are modest in the context of what has occurred:

• Gas rates have been stable for 15 years in Santa Cruz County.

• Gas rates have been stable for eight years in Citizens' northern division while the company has carried out a massive construction program.

• Electric rates have been stable in Citizens' service territory since 1997, but its plant in service has increased by 74 percent since its last test year.

• Since the summer of 2000, Citizens' ratepayers have been shielded from pricing anarchy on the western electrical grid and their electric usage has been subsidized to the tune of $135 million by the shareholders of Citizens Communications.

Against this background, the increases proposed in the Settlement Agreement are indeed modest, averaging less than the rate of inflation.

There will be rate increases in any event. The pipe is in the ground in northern Arizona and it must be paid for. No credible evidence has shown that the electric contract Pinnacle West is not prudent and it must be paid for.

There is no upside in failing to approve the Settlement Agreement. There is only uncertainty and the risk of a worse result down the road.

AUIA urges the Commission to accept the Settlement Agreement in its entirety or with very minor changes and allow the UniSource acquisition of Citizens' gas and electric assets to proceed.

Respectfully submitted this 15th day of May, 2003

Walter W. Meek

WALTER W. MEEK, PRESIDENT

CERTIFICATE OF SERVICE

Original and seventeen (17) copies of this brief were filed this 15th day of May, 2003, with:

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