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BEFORE THE ARIZONA CORPORATION COMMISSION
2007 FEB 16 A 10 18

COMMISSIONERS

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MIKE GLEASON
KRISTIN K. MAYES
GARY PIERCE

AZ CORP COMMISSION
DOCUMENT CONTROL

IN THE MATTER OF THE APPLICATION
OF ARIZONA PUBLIC SERVICE
COMPANY FOR A HEARING TO
DETERMINE THE FAIR VALUE OF THE
UTILITY PROPERTY OF THE COMPANY
FOR RATEMAKING PURPOSES, TO FIX A
JUST AND REASONABLE RATE OF
RETURN THEREON, TO APPROVE RATE
SCHEDULES DESIGNED TO DEVELOP
SUCH RETURN, AND TO AMEND
DECISION NO. 67744

DOCKET NO. E-01345A-05-0816

Arizona Corporation Commission
DOCKETED
FEB 16 2007

DOCKETED BY *NR*

IN THE MATTER OF THE INQUIRY INTO
THE FREQUENCY OF UNPLANNED
OUTAGES DURING 2005 AT PALO VERDE
NUCLEAR GENERATING STATION, THE
CAUSES OF THE OUTAGES, THE
PROCUREMENT OF REPLACEMENT
POWER AND THE IMPACT OF THE
OUTAGES ON ARIZONA PUBLIC
SERVICE CUSTOMERS

Docket No. E-1345A-05-0826

IN THE MATTER OF THE AUDIT OF THE
FUEL AND PURCHASED POWER
PRACTICES AND COSTS OF THE
ARIZONA PUBLIC SERVICE COMPANY

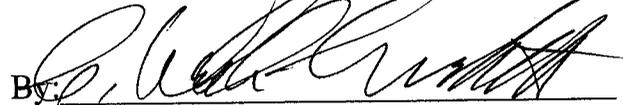
Docket No. E-1345A-05-0827

**NOTICE OF FILING OF PHELPS DODGE
MINING COMPANY AND ARIZONANS FOR
ELECTRIC CHOICE AND COMPETITION
REPLY BRIEF**

1 Phelps Dodge Mining Company and Arizonans for Electric Choice and
2 Competition ("AECC"), hereby submits its Closing Brief in the above captioned Docket.

3 RESPECTFULLY SUBMITTED this 16th day of February 2007.

4 FENNEMORE CRAIG, P.C.

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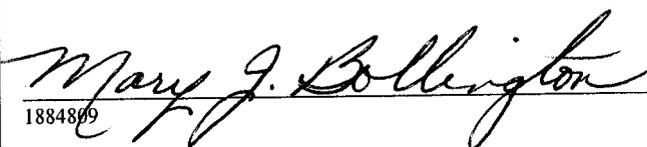
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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION
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ARIZONA PUBLIC SERVICE COMPANY.

Docket No. E-1345A-05-0827

**PHELPS DODGE MINING COMPANY AND
ARIZONANS FOR ELECTRIC CHOICE AND COMPETITION**

REPLY BRIEF

February 16, 2007

TABLE OF CONTENTS

1
2
3
4
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6
7
8
9
10
11
12
13
14
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16
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19
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Page

I. APS CORRECTLY DEPICTS THE DIFFERENCE BETWEEN ITS RECOMMENDATION FOR SETTING BASE FUEL COST, AND AECC'S RECOMMENDATION, AS BEING PRIMARILY RELATED TO THE SELECTION OF THE APPROPRIATE YEAR..... 1

II. APS'S PROPOSAL FOR EXCEPTIONS TO THE 90/10 SHARING MECHANISM IN THE PSA IS NOT COMPARABLE TO AECC'S RECOMMENDATIONS FOR CHANGES IN RATE DESIGN2

III. THE USE OF THE PROJECTED BENEFIT OBLIGATION ("PBO") IN BALANCE SHEET ACCOUNTING DOES NOT JUSTIFY THE RAISING OF RATES TO TODAY'S CUSTOMERS MAINLY TO PAY FOR PROJECTED PENSION COSTS ASSOCIATED WITH FUTURE SALARY INCREASES..... 3

IV. APS' ARGUMENT ON TRANSMISSION RATE DESIGN RESTATES THE COMPANY'S PRE-FILED TESTIMONY, BUT OVERLOOKS THE PROGRESS THAT WAS MADE IN RESOLVING THIS ISSUE AT HEARING 4

V. ALL PARTIES STATING AN OPINION HAVE EITHER EXPRESSED SUPPORT FOR, OR NON-OPPOSITION TO, AECC'S PROPOSAL TO ALLOCATE APS' HOURLY FUEL AND PURCHASED POWER COSTS BASED ON EACH CLASS'S ACTUAL USAGE FOR EACH OF THE 8,760 HOURS OF THE TEST YEAR.5

VI. STAFF'S PROPOSAL TO MODIFY THE CURRENT PSA GOES TOO FAR BY REJECTING ALL RESTRAINTS ON PRICE VARIATIONS RATEPAYERS CAN BE EXPOSED TO.....6

1 Phelps Dodge Mining Company and Arizonans for Electric Choice and
2 Competition (“AECC”), through undersigned counsel, hereby submits its Reply Brief in
3 the above-captioned docket.

4 **DISCUSSION**

5 This Reply Brief addresses final positions set forth in Arizona Public Service
6 Company’s (“APS” or “Company”) closing brief filed on January 22, 2007 relative to four
7 specific issues: (1) the establishment of Base Fuel Costs for APS, (2) exceptions to the
8 90/10 sharing mechanism in the APS Power Supply Adjustor (“PSA”), (3) APS’s
9 proposal to accelerate recovery of its underfunded pension liability, and (4) transmission
10 rate design.

11 In addition, this Reply Brief discusses the lack of opposition *by any party* to
12 AECC’s proposal to allocate APS’ hourly fuel and purchased power costs based on each
13 class’s actual usage for each of the 8,760 hours of the test year¹, as well as why Staff’s
14 proposal to modify APS’s PSA (adopting a prospective component to rate recovery) is not
15 in the public interest.

16 **I. APS CORRECTLY DEPICTS THE DIFFERENCE BETWEEN ITS
17 RECOMMENDATION FOR SETTING BASE FUEL COST, AND AECC’S
18 RECOMMENDATION, AS BEING PRIMARILY RELATED TO THE
19 SELECTION OF THE APPROPRIATE YEAR.**

20 AECC’s recommendation for setting Base Fuel Cost is based on APS’s analysis for
21 2006, which is the period of analysis APS presented in its direct case. However, APS’s
22 final recommendation for Base Fuel Cost is based on the Company’s projections for 2007.
23 On page 33 of its Closing Brief, APS indicates that this difference in the choice of year for
24 the analysis is the primary reason for the difference between AECC’s recommended Base
25 Fuel Cost and that of the Company. AECC can agree that, for the purpose of establishing

26 ¹ AECC asserts that, based on the Chief Administrative Law Judge’s instructions to the parties, if a specific issue is not addressed in a closing brief, the filing party is deemed to have taken no position thereon.

1 the Base Fuel Cost, APS changed the test year from 2006 in its original filing to 2007.
2 AECC does not believe, however, that APS's mid-proceeding change in test year for Base
3 Fuel Cost is appropriate, known or measurable. Since costs were reflective of price
4 estimates throughout 2006, this historical data provides a reasonable basis for setting the
5 base rate.

6 **II. APS'S PROPOSAL FOR EXCEPTIONS TO THE 90/10 SHARING**
7 **MECHANISM IN THE PSA IS NOT COMPARABLE TO AECC'S**
8 **RECOMMENDATIONS FOR CHANGES IN RATE DESIGN.**

9 AECC objects to APS's proposed exceptions to the 90/10 sharing mechanism in
10 the PSA on the grounds that such piecemeal alterations in APS's favor undermines the
11 PSA package that was negotiated by many of the parties in the previous APS rate
12 proceeding. Having secured an agreement for adoption of this controversial adjustor
13 mechanism, APS now attempts to further improve the benefit to the Company beyond
14 what was obtained in the previous settlement by jettisoning some of the provisions it finds
15 disadvantageous. AECC recommends that the Commission not grant such changes.
16 APS's proposed exceptions to the 90/10 sharing provision would change the balance of
17 benefits in the PSA from what was negotiated by the parties in the previous settlement.

18 APS argues that AECC's contention that the 90/10 sharing provision in the PSA
19 not be altered "rings particularly hollow" because AECC has made rate design proposals
20 in this proceeding that differ from what was adopted in the previous settlement. [APS
21 Initial Brief at 37.]. This comparison is inapt. AECC does not maintain that there cannot
22 be changes from the prior settlement since, obviously, the overall rate increase APS is
23 seeking in this proceeding represents just such a change. Rather, AECC views the PSA as
24 a mechanism that was designed with its own balance of interests – the approval of the
25 mechanism as a whole was largely to benefit APS, while various of its features (such as
26 the 90/10 sharing) represent concessions to other stakeholders. AECC urges the
Commission not to alter piecemeal the composition of the PSA to benefit *one* of the

1 stakeholders, as this would not be in the public interest.

2 **III. THE USE OF THE PROJECTED BENEFIT OBLIGATION (“PBO”) IN**
3 **BALANCE SHEET ACCOUNTING DOES NOT JUSTIFY THE RAISING**
4 **OF RATES TO TODAY’S CUSTOMERS MAINLY TO PAY FOR**
5 **PROJECTED PENSION COSTS ASSOCIATED WITH FUTURE SALARY**
6 **INCREASES.**

7 APS relies on the recently-issued Financial Accounting Standard 158 to justify the
8 Company’s proposal to raise rates \$41.2 million per year to recover its underfunded
9 pension liability, as measured by the PBO. [APS Initial Brief at 59-61]. According to
10 APS, Financial Accounting Standard 158 requires companies to reflect the PBO on their
11 financial statements [Tr. Vol IV at p. 776-777]. However, the PBO includes the pension
12 cost associated with projected future salary increases. [Direct Testimony of Kevin C.
13 Higgins at 11]. In the case of APS, the portion of PBO associated with future salary
14 increases is \$233 million, comprising the majority of its underfunded pension liability.
15 [Id.] While including the projected impact of future salary increases on pension liability
16 may now have a role in balance sheet accounting, it does not follow that this new
17 reporting requirement should trump sound ratemaking principles. By definition, the
18 future salary increases have not yet occurred. Having today’s ratepayers recover
19 “underfunded” pension costs associated with salary increases that have not yet occurred
20 results in inter-generational inequities across ratepayers. Such a practice is inconsistent
21 with good ratemaking.

22 Instead, for ratemaking purposes, regulators are better served by focusing on the
23 accumulated benefit obligation (“ABO”), which is identical to the PBO except for the
24 treatment of future salary increases. [Id.] APS’ underfunded pension liability as
25 measured by the ABO is less than half the size of the PBO. [Id.] Further, the ABO will
26 be adjusted each year to reflect *actual* salaries as these salaries change over time. [Tr. Vol
II, p. 423, line 23 – p. 424, line 6]. In this way, measurement of underfunded pension
liability for ratemaking purposes will appropriately reflect current – and not future –

1 salaries, preserving intergenerational equity in the setting of current rates.

2 **IV. APS' ARGUMENT ON TRANSMISSION RATE DESIGN RESTATES THE**
3 **COMPANY'S PRE-FILED TESTIMONY, BUT OVERLOOKS THE**
4 **PROGRESS THAT WAS MADE IN RESOLVING THIS ISSUE AT**
5 **HEARING.**

6 At hearing, APS witness Rumolo and AECC witness Higgins agreed that an
7 appropriate resolution of the differences in their respective pre-filed positions on
8 transmission rate design would be to set the retail rate for transmission service equal to the
9 rates in Schedule 11 of APS' Open-Access Transmission Tariff ("OATT"), with some
10 provision for the smallest E-32 customers to be billed on an energy-only basis. [Tr. at
11 Vol. XIV, p. 2790, lines 2-9; Vol. XV, p. 3070, line 15 - p. 3071, line 2]. However, APS'
12 Initial Brief fails to acknowledge the progress that was made in resolving this issue and
13 reverts to a restatement of the Company's pre-filed position.

14 By its own terms, APS' restatement of its pre-filed position in its Initial Brief is
15 fraught with contradictions. At page 91, APS states that "Because production-related and
16 *transmission-related* assets, and their associated costs, are generally designed and built to
17 enable the Company to meet its system peak load, they are *allocated on the basis of the*
18 *average of the system peak demands occurring in the months of June, July, August, and*
19 *September ("4 CP")*. [Emphasis added]. Yet, at page 89, APS defends its use of an
20 "energy-only" transmission charge and objects to AECC's allocation of transmission costs
21 on a 4 CP basis by stating that "'allocation" of OATT charges in applying a demand
22 allocator, such as the 4 CP allocator, does not reflect an accurate representation of how the
23 costs are incurred to provide transmission service and is, therefore, inappropriate." These
24 two statements are in direct contradiction. If the proper method for allocating
25 transmission costs is the 4 CP method, as APS states on page 91, then it is appropriate to
26 allocate costs this way. Moreover, APS's reliance on the OATT as a justification for an
energy-only charge is itself a contradiction: the OATT sets retail transmission rates for

1 non-residential customers greater than 20 kW based on *demand* (as AECC and others
2 recommend) and *not* on energy.

3 The obvious resolution to this issue is the one that AECC and APS proposed at
4 hearing: simply set retail transmission rates equal to the rates in Schedule 11 of APS's
5 OATT, while providing for the smallest E-32 customers (i.e., those with billing demands
6 less than 100 kW) to be billed on an energy-only basis, per the OATT rate for small
7 General Service customers. As testified by APS witness Rumolo, the OATT rates are the
8 very charges that APS must pay for transmission service for its retail customers. There is
9 no more straightforward means for properly recovering these costs than to charge these
10 very same rates to the retail customers themselves.

11 **V. ALL PARTIES STATING AN OPINION HAVE EITHER EXPRESSED**
12 **SUPPORT FOR, OR NON-OPPOSITION TO, AECC'S PROPOSAL TO**
13 **ALLOCATE APS' HOURLY FUEL AND PURCHASED POWER COSTS**
14 **BASED ON EACH CLASS'S ACTUAL USAGE FOR EACH OF THE 8,760**
15 **HOURS OF THE TEST YEAR.**

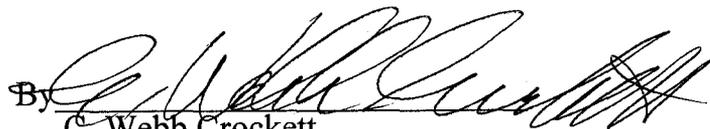
16 AECC's enhancement to APS's cost-of-service study better aligns the allocation of
17 APS' energy cost with cost causation. [AECC Initial Brief at p. 21.] Referring to
18 AECC's proposal, Kroger witness Baron testified that "it is indisputable that that would
19 be a more precise measure of the responsibility for energy related costs of each class."
20 [FEA Post Hearing Brief at p. 7] AECC's proposal is strongly supported by FEA, which
21 recommends unequivocally that "The Commission should adopt the hourly energy cost
22 allocator proposed by PDMC/AECC witness Kevin Higgins." [*Id.* at p. 6]. Further, APS
23 states that the Company "does not oppose this adjustment to its cost of service study."
24 [APS Initial Brief at p. 92]. Neither Commission Staff, RUCO nor any other party
25 commented on AECC's proposal in their closing briefs. In short, there is strong support
26 for, and no opposition to, AECC's proposal in the record of this proceeding. AECC urges
the Commission to adopt the proposal.

1 VI. STAFF'S PROPOSAL TO MODIFY THE CURRENT PSA GOES TOO FAR
2 BY REJECTING ALL RESTRAINTS ON PRICE VARIATIONS
3 RATEPAYERS CAN BE EXPOSED TO.

4 AECC's main concerns with Staff's proposed form of PSA involve its
5 "prospective" component, which the Commission: (1) has not utilized in the past, (2) is
6 unfamiliar with in administering, and (3) most of all, abolishes bargained-for benefits by
7 parties to the Settlement Agreement that have been refined into a workable adjustor. As
8 set forth in RUCO's Initial Post Hearing Brief, "It would be premature to discard those
9 efforts and adopt a PSA that is based on a completely different philosophical
10 underpinnings than the current PSA." RUCO Initial Brief at 40, lines 10 - 12. Staff
11 proposes to eliminate the 90/10 sharing mechanism, which currently acts as a strong
12 incentive to making prudent energy transactions. Staff's position on this matter is indeed
13 out of touch with recent Commission decisions concerning adjustor mechanisms. *Id.* at
14 43. AECC supports RUCO's position concerning Staff's proposed PSA for many of the
15 reasons set forth in its Initial Post-Hearing Brief.

16 RESPECTFULLY SUBMITTED this 16th day of February, 2007.

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