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March 19, 2002

VIA HAND DELIVERY

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

E-01032C-00-0751

Re: *Citizens Rejoinder Testimony;*
Docket No. E-01032C-0751

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2002 MAR 19 P 4:40
AZ CORP COMMISSION
DOCKET CONTROL

Dear Sir/Madam:

Enclosed and filed this date are the rejoinder testimonies of William E. Avera, Sean R. Breen, Paul M. Flynn, Carl W. Dabelstein, Patricia M. Eckert, Tom J. Ferry and Lyle D. Miller, on behalf of Citizens Communications Company in this docket.

Very truly yours,

GALLAGHER & KENNEDY, P.A.

By: Michael M. Grant

MMG:bo
Enclosures

Original and ten copies filed this
19th day of March, 2002, with:

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

Arizona Corporation Commission
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Docket Control
March 19, 2002
Page 2

COPY of the foregoing hand-delivered
this 19th day of March, 2002 to:

Lyn Farmer
Chief Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 W. Washington
Phoenix, AZ 85007

COPIES of the foregoing mailed this
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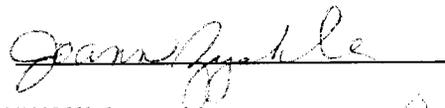
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March 19, 2002
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By:

A handwritten signature in cursive script, appearing to read "John White", is written over a horizontal line. The signature is written in dark ink.

3099-0039/1002661v1

A small, handwritten mark resembling a zero or a drop, located below the signature line.

1
2 **REJOINDER TESTIMONY**
3 **OF**
4 **WILLIAM E. AVERA**

5
6 **CONSULTANT FOR**
7 **CITIZENS COMMUNICATIONS COMPANY**
8 **ARIZONA ELECTRIC DIVISION**

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11 **DOCKET NO. E-01032C-00-0751**
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26 **MARCH 19, 2002**
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1 **INTRODUCTION AND QUALIFICATIONS**

2 Q. Please state your name and business address.

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

4
5 Q. Are you the same William E. Avera who previously filed rebuttal testimony
6 in this case?

7 A. Yes, I am.

8
9 Q. What is the purpose of your rejoinder testimony in this case?

10 A. My purpose here is to respond to the surrebuttal testimony of Ms. Lee
11 Smith and Mr. Douglas Smith on behalf of the Arizona Corporation
12 Commission ("ACC" or the "Commission") Staff and Dr. Richard A. Rosen on
13 behalf of the Arizona Residential Utility Consumer Office ("RUCO"). In
14 addition, this testimony contains schedules identical to those contained in
15 my direct testimony, only revised to correct a typographical error and
16 updated to reflect Staff's current recommendations.

17
18 Q. What are the principal conclusions of your rejoinder testimony?

19 A. No Staff or RUCO witness disputes financial impact on the Arizona Electric
20 Division of Citizen's Communications Company ("AED" or the "Company")
21 that is presented in my rebuttal testimony and confirmed in my corrected
22 calculations. Nor do they offer any evidence to objectively quantify the
23 impact of any alleged imprudence on the AED's purchased power costs.
24 Instead, they continue to offer speculative suggestions of actions that
25 management might have taken that possibly could have lowered costs or
26 may have potentially resulted in refunds at some unknown time in the
27 future. In the real world, the AED's customers have benefited from the
28 Company's vigorous negotiation in the face of unprecedented and
29

1 unpredicted power market conditions to achieve a stable power supply
2 agreement. The recommendations of Staff and RUCO would not serve
3 customers well and would likely have negative spillover effects on utility
4 customers throughout Arizona.

5
6 Q. Please explain the corrections made to Schedules WEA-1 and WEA-2
7 contained in your rebuttal testimony.

8 A. Due to a typographical error, the cost rate assigned to the preferred stock
9 component of the AED's capital structure was shown as 5.75 percent,
10 rather than the 5.075 percent authorized by the ACC. Accordingly,
11 Schedules WEA-3 and WEA-4 are identical to the analyses presented in my
12 rebuttal testimony, only revised to reflect this correction.

13
14 Q. Did this correction have any appreciable impact on the results of your
15 analyses?

16 A. No. As shown on Schedule WEA-3, after making this correction the overall
17 rate of return implied by the recommendations presented in Staff's direct
18 testimony was revised downward to 4.71 percent, versus the 4.73 percent
19 shown on Schedule WEA-1. Similarly, Schedule WEA-4 indicates that the
20 implied pre-tax coverage ratio based on Ms. Smith's direct testimony fell to
21 1.24 times from the 1.25 times contained on Schedule WEA-2. These
22 changes are insignificant and have no impact on my conclusion that the
23 recommendations of Staff and RUCO would spell financial disaster for the
24 AED.

1 Q. Have you updated these analyses to reflect Staff's most recent
2 recommendations?

3 A. Yes. In Ms. Smith's surrebuttal testimony (pp. 16-17), Ms. Smith updates
4 her recommendations to reflect an estimated PPFAC bank balance at the
5 end of April 2002, which she estimates will total approximately \$105
6 million. Of this balance, Ms. Smith recommends that \$7 million be denied
7 as imprudent. Staff proposes that \$28 million of the PPFAC bank balance
8 be collected over a three-to-four year period, with the remaining \$70
9 million in uncollected power costs being deferred indefinitely until issues
10 related to Arizona Public Service Company's ("APS") billing practices under
11 the Old Contract have been "pursued". Staff continues to recommend that
12 no carrying costs be permitted on the deferred balances accumulated in the
13 PPFAC bank.

14
15 Q. What are the results of your updated analyses?

16 A. As shown on Schedules WEA-5 and WEA-6, incorporating Staff's most
17 recent estimates only serves to make the financial impact of their
18 recommendations more extreme. As shown on Schedule WEA-5, Ms.
19 Smith's proposal to deny a return on approximately \$98 million of deferred
20 power costs accumulated in the PPFAC bank would imply an overall rate of
21 return for the AED of 4.26 percent. Similarly, the 1.08 times pre-tax
22 coverage ratio produced by Staff's updated recommendations (Schedule
23 WEA-6) falls far below the level necessary to support the AED's financial
24 integrity or ability to attract capital on reasonable terms. Accordingly, the
25 results of these updated analyses only serve to reinforce the conclusions of
26 my rebuttal testimony that Staff's and RUCO's recommendations would
27 destroy AED's financial integrity, in violation of established regulatory and
28 legal standards, not to mention all notions of fairness.

29

1 Q. Does the surrebuttal testimony of the Staff and RUCO provide any
2 meaningful support for their extreme proposals?

3 A. No. Staff and RUCO witnesses continue their attempts to support their
4 extreme recommendations based on unfounded suppositions regarding the
5 AED's ability to anticipate wholesale power market conditions and the
6 potential outcome of alternative actions suggested in hindsight. Ms. Smith
7 suggests that with more or different attorneys and consultants, the
8 outcome of the AED's negotiations may have been different (p. 4). She
9 also believes that a filing at the Federal Energy Regulatory Commission
10 ("FERC") might have created more leverage (p. 6). Staff speculates in its
11 surrebuttal testimony that more attention to wholesale power market
12 conditions might have led to a hedging strategy that could have avoided
13 some of the purchased power expenses incurred during the Summer of
14 2000 (L. Smith at p.9, D. Smith at pp. 4-13). Similarly, Dr. Rosen also
15 believes that a FERC filing would have resulted in lower power costs,
16 although the timing is uncertain (p. 1) and that the ACC may be able to
17 force APS to abide by the terms of the Old Contract and change its planning
18 to benefit the AED (p. 10).

19
20 While the merits of these specific arguments are addressed in the
21 testimony of the AED's witnesses, nowhere in any of the Staff or RUCO
22 testimony has any attempt been made to quantify what the AED's power
23 costs should have been under reasonable management. Moreover, the
24 standard for evaluating management actions in the regulatory arena is
25 neither perfection nor clairvoyance. It is whether management made
26 reasonable decisions given the information available at the time the
27 decisions were made.

1 Q. Do the suppositions contained in the testimony of the Staff and RUCO
2 constitute a reasonable basis on which to base a finding of imprudence or
3 disallowance?

4 A. No. In my experience, where a commission does disallow costs, there is
5 specific evidence that management failed in its responsibilities and the
6 amounts disallowed are based on objective analyses of what the reasonable
7 and necessary costs should have been. Never have I encountered such a
8 dramatic penalty as proposed by Staff and RUCO in this case. Nor have I
9 ever seen a proposed disallowance based on such speculative and
10 unsupported notions of what might have constituted necessary costs under
11 reasonable management.

12
13 Q. Does Staff's clarification of its position regarding negotiations (p. 7-8)
14 illustrate their lack of objective evidence for a prudence finding?

15 A. Yes. In her surrebuttal testimony, Ms. Smith apparently clarifies Staff's
16 position regarding the outcome of dealings with APS, suggesting that "more
17 intensive" renegotiations may not have changed the outcome, only that:

18 The issue is more a matter of whether Citizens conducted
19 effective negotiations and when it did so. (p. 7)

20
21 Ms. Smith's clarification only weakens the already tenuous support for
22 Staff's extreme recommendations. The Staff apparently has given up any
23 argument that more vigorous renegotiations would have led to lower
24 purchased power costs, as I dismissed in my rebuttal testimony. Now Ms.
25 Smith asserts that her suppositions over the timing and results of the AED's
26 negotiation efforts are sufficient to prove up her proposals to gut the
27 Company's financial viability. While the fallacy of Ms. Smith's contentions is
28

1 demonstrated in the testimony of the AED's witnesses, her position on this
2 issue only illustrates the frailty of the "evidence" underlying Staff's and
3 RUCO's recommendations.
4

5 Q. Did Staff present any evidence to rebut your contention that the degree of
6 price volatility experienced in wholesale markets was unanticipated?

7 A. No. In fact Staff again apparently softens its position, this time regarding
8 the AED's ability to anticipate the unprecedented power market conditions
9 that began in Summer 2000. Mr. Smith does not claim that market
10 participants were well aware of the impending crisis, or that the AED should
11 have known with certainty how market prices would turn out. Rather, Staff
12 only asserts that certain sources indicated the "potential" for higher prices
13 and then uses this as a bootstrap to support disallowances that would
14 effectively destroy the financial viability of the AED.
15

16 Of course, it is a fact that liquid markets for electricity, just like common
17 stock, are driven by differences in opinions and forecasts regarding the
18 course of future events. Thus, it comes as no surprise that Mr. Smith was
19 able to find a reference in *Power Market Week* that supports the potential
20 for higher prices during the Summer of 2000. Nor is it remarkable that in
21 hindsight he was able to construct a mosaic of other data that would be
22 suggestive of tightening power supplies in the West.
23

24 What is relevant is that the conclusion Mr. Smith draws from these
25 observations – that the AED was somehow derelict in its responsibilities – is
26 not borne out by events in the marketplace or Staff's evidence. As I amply
27 demonstrated in my rebuttal testimony, the events that transpired
28 beginning in Summer 2000 came as a shock to all market participants,
29

1 including those involved in the ACC's planning forum in May 2000. Even
2 the ICF/Kaiser Consulting Group study cited by Staff as an "explicit
3 warning" of higher prices was hardly unequivocal, calling for a "one-in-
4 three" chance of price spikes analogous to those experienced in the
5 Midwest during 1998.¹ But the run-up in wholesale prices in the Midwest
6 was a transitory event that lasted from June 22-26, with prices reverting to
7 their expected ranges within a week. Moreover, as noted in my rebuttal
8 testimony, this very same consulting firm continued to anticipate serious
9 shortages through the Summer of 2001. As a young man I served as a
10 weather forecaster in the Navy. My Senior Chief Petty Officer taught me
11 that if you make enough forecasts, some will be right on the money and
12 others will be completely wrong. You don't know beforehand which will be
13 which.

14
15 Mr. Smith also attempts to support his conclusions by reference to Pacific
16 Gas & Electric Company's ("PG&E") requested authority for Block Forward
17 Market purchases (p. 10). Ignoring the extent to which these purchases
18 were motivated by specific Path 15 transmission constraints, the ultimate
19 bankruptcy of PG&E only serves to illustrate the absurdity of the Staff's
20 position that the AED should reasonably have been expected to hedge
21 against unforeseen market volatility because PG&E did. Finally, while Staff
22 admits that:

23
24 It is not possible to cleanly demonstrate the savings from a
25 financial hedge, because such transactions are not always
26 conducted in standard amounts using standard terms, and are
27 not typically reported in the trade press. (p. 12)

28
29

¹ Direct Testimony of Lee Smith at p. 27.

1 Mr. Smith speculates that the AED would have realized millions of dollars in
2 benefits associated with a hedging transaction. This speculation provides
3 yet another indication of the lack of objective support provided for the
4 Staff's extreme recommendations in this case.

5
6 Q. Do you agree with Ms. Smith's contention that it is "normal ratemaking
7 policy" to reduce the allowed rate of return if management performance is
8 found to be deficient (p. 19)?

9 A. No. While Ms. Smith grants that the AED's authorized rate of return "does
10 reflect a prior Commission judgment about risk", she attempts to justify a
11 departure from its treatment as a stand-alone, low risk utility by asserting
12 that downward reductions to authorized returns are common practice. In
13 contrast to Ms. Smith's assertion, however, adjustments to the allowed rate
14 of return to recognize a perceived deficiency in management performance
15 are extremely rare and hardly constitute "normal ratemaking policy". I
16 have participated in hundreds of utility cases over my thirty-year career as
17 a commission staff member and consultant to commissions, intervenors,
18 and utilities. In my experience, a reduction to the rate of return through an
19 explicit penalty or major disallowance of cost is the exception, not the rule.
20 This is particularly true when fuel and purchased power expenses are
21 involved since these costs are typically flowed through to customers
22 without the utility earning a return.

23
24 Moreover, the magnitude of performance-based adjustments that have
25 been authorized by other regulators only serve to further illustrate how far
26 Staff's extreme proposals have strayed from what might be considered
27 "normal". These downward adjustments to the return on equity have
28 generally fallen in the range of 25 to 50 basis points, versus the 462 basis-

1 point "penalty" to the AED's overall rate of return implied by Ms. Smiths
2 recommendations.²
3

4 Q. Ms. Smith claims that "power costs could have been reduced through
5 prudent actions on the part of Citizens" (p. 20). Do you agree that this
6 justifies the drastic regulatory penalties Staff and RUCO propose?

7 A. No. First, let me make clear that the testimony of the AED's witnesses
8 establishes that there is no evidence of imprudence on the part of the
9 Company's management. Second, the penalties must be predicated on a
10 realistic benchmark for prudent purchased power costs. Neither Staff nor
11 RUCO present any meaningful evidence on what might constitute such an
12 objective benchmark. Rather, they merely suggest a number of actions
13 that they speculate might have affected the AED's purchased power costs
14 or make comparisons with invalid yardsticks, such as historical costs or
15 current market prices. Apart from ignoring the market realities faced by
16 the AED and the concrete steps that management took to address power
17 cost volatility, these general suppositions provide no objective basis to
18 evaluate or quantify the magnitude of any alleged imprudence.
19

20 Q. Please address Ms. Smith's comment that the AED's ability to attract capital
21 may not be relevant since it is not a stand-alone company (p. 20).

22 A. As explained in my rebuttal testimony (pp. 14-15), the AED has historically
23 been viewed by the ACC, Staff, and RUCO as a low risk, stand-alone utility,
24 with Ms. Smith recognizing this "prior Commission judgment" (p. 19)
25 concerning the AED in her surrebuttal testimony. Now, however, Ms. Smith
26

27
28 ² Computed as the difference between the 8.88% overall rate of return authorized in the AED's
29 last rate case and the 4.26% return implied by Staff's recommendations, as presented on
Schedule WEA-5.

1 suggests that it is "not clear" that an analysis of the financial impact of her
2 recommendations on the AED is relevant, presumably because the
3 Company is a division on Citizens Communications Company ("Citizens").
4

5 In fact, an examination of the financial implications for the AED as a stand-
6 alone utility is the *only* relevant basis to evaluate Staff's proposals. Not
7 only is such an approach consistent with the ACC's prior treatment of the
8 AED, it reflects well-established regulatory policy separating jurisdictional
9 and non-jurisdictional activities. Indeed, the corollary of Ms. Smith's
10 suggestion implies that the AED's customers should also be required to
11 make up any shortfalls in the returns of Citizens' local exchange telephone
12 operations and maintain the financial viability of its other diversified
13 businesses. Customers have clearly benefited from Citizens' ongoing
14 support of the AED in order to ensure that the Company continues to meet
15 its service obligations in the face of unparalleled financial stress. Ms.
16 Smith's veiled suggestion that Citizens should now be penalized for this
17 commitment to the AED stands in stark contrast to the Company's past
18 treatment by the ACC, established regulatory policy, and any notion of
19 equity or fairness.
20

21 Q. Dr. Rosen claims that the AED did not "keep the interest of ratepayers
22 uppermost in its mind" (p. 2). Were the AED's actions consistent with
23 customers' best interests?

24 A. Yes. Ratepayers are interested in reliable electric service at reasonable
25 prices. The AED knew that, unless it paid its bills to APS, the lights would
26 go out. The AED was also mindful of the impact that escalating power costs
27
28
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1 would ultimately have on customers and the potential for ongoing market
2 volatility. Therefore, the strategy of negotiating with APS to lower power
3 costs and enhance price stability was entirely consistent with ratepayers'
4 interests.

5
6 Q. Are Dr. Rosen's recommendations consistent with the interests of
7 ratepayers?

8 A. No. Customers are not well served when their utility loses its financial
9 integrity and ability to attract capital. The devastating penalty urged by Dr.
10 Rosen would not only gut the AED, it would likely have negative fallout for
11 all utilities serving in Arizona. Investors consider regulatory risk in
12 evaluating required rates of return for utility investments subject to state
13 regulation. Indeed, the U.S. Supreme Court recognized these regulatory
14 risks in *Duquesne Light Co. et al. v. Barasch et al.* (488 U.S. 299).

15
16 In addition, Dr. Rosen is not mindful of ratepayers' right to know the cost of
17 electricity when they make decisions regarding consumption and equipment
18 purchases in their homes, farms, and businesses. Dr. Rosen would have
19 the PPFAC bank balance build up over years of litigation (p. 7) while
20 customers operate under incorrect price signals. When the litigation is
21 resolved and the ultimate costs are flowed through, customers do not have
22 the opportunity to undo consumption or equipment purchase decisions of
23 the past that were based on under-priced electricity. Moreover, there
24 would be a mismatch between those customers whose use corresponded to
25 mounting power costs and those who would ultimately pay. Customers
26 who move out of the AED's service territory would enjoy a windfall while
27 those establishing new service would pick up the tab for power costs
28 previously incurred.

1 Q. Does this conclude your rejoinder testimony?

2 A. Yes, it does

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AUTHORIZED OVERALL RATE OF RETURN -- CORRECTEDACC 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%	\$ 2,810,476
Preferred Stock	6%	\$ 5,422,141	5.075%	\$ 280,144
Common Equity	51%	\$ 46,088,195	10.70%	\$ 4,934,148
Total		\$ 90,369,010		\$ 8,024,768
Implied Overall Rate of Return				<u>8.88%</u>

RESULTING OVERALL RATE OF RETURN -- CORRECTEDSmith 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%	\$ 2,810,476
Preferred Stock	3%	\$ 5,422,141	5.075%	\$ 280,144
Common Equity	27%	\$ 46,088,195	10.70%	\$ 4,934,148
Total		\$ 170,369,010		\$ 8,024,768
Implied Overall Rate of Return				<u>4.71%</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 -- CORRECTED

<u>Component</u>	<u>%</u>	(a)	(a)	(b)	<u>Pre-tax Cost</u>	<u>Pre-tax Return</u>
		<u>Invested Capital (a) Amount</u>	<u>Cost Rate (a)</u>	<u>Tax Factor</u>		
Long-term Debt	43%	\$ 38,858,674	7.23%	1.0000	7.23%	\$ 2,810,476
Preferred Stock	6%	\$ 5,422,141	5.075%	1.5152	7.69%	\$ 416,930
Common Equity	51%	<u>\$ 46,088,195</u>	10.70%	1.5152	16.21%	<u>\$ 7,471,874</u>
		\$ 90,369,010				\$ 10,699,280

IMPLIED COVERAGE - ACC ORDER (a)

Total Pre-Tax Return	\$ 10,699,280
Interest Charges	<u>\$ 2,810,476</u>
Coverage Ratio	<u><u>3.81X</u></u>

IMPLIED COVERAGE - STAFF RECOMMENDATION

Total Allowed Pre-Tax Return	\$ 10,699,280
Interest Charges	
Long-term Debt	\$ 2,810,476
Deferred PPFAC Bank Balance (c)	
Amount	\$ 80,000,000
Cost Rate	7.23%
	<u>\$ 5,784,000</u>
Total Interest Charges	<u>\$ 8,594,476</u>
Coverage Ratio	<u><u>1.24X</u></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.

AUTHORIZED OVERALL RATE OF RETURN -- UPDATEDACC 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%	\$ 2,810,476
Preferred Stock	6%	\$ 5,422,141	5.075%	\$ 280,144
Common Equity	51%	\$ 46,088,195	10.70%	\$ 4,934,148
Total		\$ 90,369,010		\$ 8,024,768
Implied Overall Rate of Return				<u>8.88%</u>

RESULTING OVERALL RATE OF RETURN -- UPDATEDSmith Recommendations (b)

<u>Component</u>	<u>Invested Capital</u>		<u>Cost Rate</u>	<u>Return</u>
	<u>%</u>	<u>Amount</u>		
PPFAC Balance				
Deferred		\$ 70,000,000	0%	\$ -
Allowed		\$ 28,000,000	0%	\$ -
	52%	\$ 98,000,000		
Long-term Debt	21%	\$ 38,858,674	7.23%	\$ 2,810,476
Preferred Stock	3%	\$ 5,422,141	5.075%	\$ 280,144
Common Equity	24%	\$ 46,088,195	10.70%	\$ 4,934,148
Total		\$ 188,369,010		\$ 8,024,768
Implied Overall Rate of Return				<u>4.26%</u>

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

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

IMPLIED COVERAGE RATIOS -- UPDATED

<u>Component</u>	<u>%</u>	(a)	(a)	(b)	<u>Pre-tax Cost</u>	<u>Pre-tax Return</u>
		<u>Invested Capital (a) Amount</u>	<u>Cost Rate (a)</u>	<u>Tax Factor</u>		
Long-term Debt	43%	\$ 38,858,674	7.23%	1.0000	7.23%	\$ 2,810,476
Preferred Stock	6%	\$ 5,422,141	5.075%	1.5152	7.69%	\$ 416,930
Common Equity	51%	<u>\$ 46,088,195</u>	10.70%	1.5152	16.21%	<u>\$ 7,471,874</u>
		\$ 90,369,010				\$ 10,699,280

IMPLIED COVERAGE - ACC ORDER (a)

Total Pre-Tax Return	\$ 10,699,280
Interest Charges	<u>\$ 2,810,476</u>
Coverage Ratio	<u>3.81X</u>

IMPLIED COVERAGE - STAFF RECOMMENDATION

Total Allowed Pre-Tax Return	\$ 10,699,280
Interest Charges	
Long-term Debt	\$ 2,810,476
Deferred PPFAC Bank Balance (c)	
Amount	\$ 98,000,000
Cost Rate	7.23%
	<u>\$ 7,085,400</u>
Total Interest Charges	<u>\$ 9,895,876</u>
Coverage Ratio	<u>1.08X</u>

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

(b) Assumes tax rate of 34 percent.

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

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2 **REJOINDER TESTIMONY**
3 **OF**
4 **SEAN R. BREEN**
5 **CITIZENS COMMUNICATIONS COMPANY**
6 **ARIZONA ELECTRIC DIVISION**

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9 **DOCKET NO. E-01032C-00-0751**

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26 **MARCH 19, 2002**
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1 Q. Please state your name and business address.

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

5

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

8 A. Yes, I am.

9

10 Q. What is the purpose of your rejoinder testimony?

11 A. My rejoinder testimony addresses statements made by Arizona Corporation
12 Commission ("Commission") Staff witness Lee Smith and Residential Utility
13 Consumer Office ("RUCO") witness Richard Rosen in their respective
14 surrebuttal testimonies. I will address each witness' testimony in turn.

15

16 **SURREBUTTAL TESTIMONY OF LEE SMITH**

17 Q. Does Ms. Smith present any compelling reasons in her surrebuttal
18 testimony to support her position of denying Citizens recovery of power
19 costs and carrying charges in connection with Citizens deferred PPFAC
20 costs?

21 A. No. Her surrebuttal testimony for the most part reiterates previous
22 positions, which have been rebutted by Citizens' witnesses, but also
23 contains statements that are incorrect or that mischaracterize actual
24 events.

25

26 Q. In what areas does Ms. Smith make incorrect statements?

27 A. Ms. Smith's surrebuttal testimony contains such statements in several
28 areas, including:

29

- 1 1. Citizens retention of outside counsel and expert advice prior to
- 2 December 2000;
- 3 2. The characterization of Citizens' negotiation efforts and tactics;
- 4 3. Citizens prescience regarding actions APS would take;
- 5 4. The significance of market price projections; and
- 6 5. The Valencia facilities.

7
8 Q. Is Ms. Smith correct in stating that Citizens did not retain expert technical
9 and legal assistance regarding the APS contract disputes prior to December
10 2000?

11 A. No. Putting aside the fact that Citizens' own personnel, who have worked
12 and continue to work on this matter, collectively represent a very
13 significant body of industry knowledge and experience, Citizens did in fact
14 retain both outside legal counsel and technical consultants to assist with
15 APS contract matters well before December 2000. Citizens retained Stone
16 & Webster Management Consultants, Inc. ("S&W") in early 1998, and R. J.
17 Rudden & Associates, Inc. in February 2000 to provide technical and
18 regulatory support to Citizens negotiation efforts. In October 1999,
19 Citizens retained outside legal support from the firm Troutman Sanders,
20 LLP to assist in FERC contract interpretation matters. Ms. Smith herself,
21 prior to submitting direct testimony in this proceeding, participated in
22 conference calls with the R. J. Rudden associate (and former S&W
23 consultant) who assisted Citizens. Ms. Smith is simply incorrect in her
24 statements that Citizens did not retain adequate and appropriate outside
25 assistance throughout this period.

1 Q. Did Ms. Smith surrebuttal testimony also mischaracterize or
2 miscomprehend Citizens' negotiation efforts and tactics in its interactions
3 with APS?

4 A. Yes, it did, in several areas, as enumerated below:

- 5 1. Ms. Smith mischaracterizes Citizens' interactions with APS over
6 contract interpretation issues prior to summer 2000 as a "debate,"
7 when in fact the Company was employing a deliberate and focused
8 negotiation strategy.
- 9 2. Her testimony suggests that Citizens should have pursued actions
10 that would have completely undermined its negotiation position at the
11 time.
- 12 3. She incorrectly asserts that Citizens did not achieve negotiation
13 leverage by retaining expert advice when in fact it had employed such
14 services for many months.
- 15 4. She suggests that negotiations prior to spring 2001 did not involve
16 written statements of Citizens' position even though such statements
17 were provided in response to data requests.
- 18 5. She asserts that Citizens' only outcome of the May 18, 2000,
19 Memorandum of Understanding ("MOU") was "nothing except a \$1.5
20 million refund," which is a complete mischaracterization of the
21 document.

22
23 Q. What did Ms. Smith suggest about Citizens negotiations with APS prior to
24 summer 2000?

25 A. Ms. Smith characterized these negotiations as a "debate." I conclude from
26 her statements that, at best, Ms. Smith has misunderstood the actual
27 events that transpired during this period or, at worst, is attempting to
28 trivialize the deliberate, focused, and effective steps taken by Citizens.

1 Summarizing briefly my rebuttal testimony, the actual steps taken and
2 events that occurred during the May 1999 through summer 2000 period
3 are: 1) Citizens appropriately investigated a significant APS billing
4 adjustment and determined the substance of the contract interpretation
5 issues; 2) discussions followed, which by the spring of 2000, had escalated
6 to the senior management level at both companies to the point of Citizens
7 indicating it would take regulatory actions without movement by APS (an
8 exchange of correspondence on this matter— attached as an exhibit to my
9 testimony-- was provided to Staff in response to Staff Data Request LS
10 5.11); 3) the pressing need at APS to alter contract language to facilitate
11 its pending Market-Based Rates Filing provided the necessary motivation
12 that brought APS back to the negotiating table; and 4) as a result, Citizens
13 obtained the concessions it sought to restructure the contract (*and secure a*
14 *refund*), by agreeing not to intervene in a particular FERC proceeding. To
15 characterize that sequence of events as a "debate" is simply absurd.

16
17 Q. Ms. Smith suggests that a complaint filed at the FERC during this period
18 would have been a "good bargaining chip." Is she correct?

19 A. Absolutely not. Such a filing would have derailed the negotiation strategy
20 that was underway. By early 2000, the companies had reached an impasse
21 in their discussions. However, Citizens understood that APS "needed
22 something" (i.e. agreement not to interfere with its pending FERC
23 proceeding). Knowing this, Citizens deliberately withheld its consent on the
24 FERC issue until APS "came to the table," which it ultimately did. If Citizens
25 had filed a complaint during this period, it would have hardened APS'
26 position, ended productive discussions, and Citizens would have lost its
27 advantageous negotiating position. That position ultimately led to the May
28 2000 MOU that achieved Citizens' negotiation objectives at the time.

1 Q. Why do you believe Ms. Smith asserts that Citizens did not employ
2 adequate expert advice to leverage its negotiations?

3 A. I frankly am perplexed as to why Ms. Smith has made these statements.
4 In December 2001, she spoke with the consultant, who had been advising
5 Citizens since 1998, and learned that he had formerly spent ten years on
6 FERC Staff. While I have not been able to research whether responses to
7 any previous data requests had referenced Troutman Sanders, the legal
8 firm that had advised Citizens since October 1999 regarding APS contract
9 issues, she should have sought direct information about this matter before
10 making such sweeping allegations about Citizens in this regard. I can only
11 conclude that she is attempting to obfuscate the fact that Citizens did in
12 fact take aggressive, well-advised, and reasonable actions to change its
13 contract with APS. The events of the summer of 2000 were unanticipated,
14 unprecedented, and unfortunate. It is tempting to look back at the severity
15 of the events that occurred that summer and thereafter and conclude, as
16 Ms. Smith has, that Citizens should have tried harder. In fact Citizens
17 achieved its negotiating objectives by bringing APS to the point of agreeing
18 to change the former contract. Ms. Smith is merely employing hindsight
19 and ignoring facts to criticize the actions taken by Citizens, which were
20 reasonable and appropriate given the information available to it at the time.

21
22 Q. When you state the Citizens "achieved its negotiating objectives," are you
23 referring to the May 18, 2000, MOU?

24 A. Yes.
25
26
27
28
29

1 Q. Ms. Smith states that Citizens "got nothing except the \$1.5 million" from
2 the MOU. Is she correct?

3 A. One again, absolutely not. Ms. Smith attached the MOU to her direct
4 testimony (response to Staff Data Request LS 5.44), so clearly she has
5 read the document. That document also set the principles for how a new
6 contract, that would replace most of the existing Service Schedules, would
7 be priced and set the terms under which Citizens would be able to reduce
8 the contract demand under the base load block of Service Schedule A based
9 on competitive sales loss—all objectives that Citizens sought. Ms. Smith is
10 aware, as set forth in my rebuttal testimony, that APS reversed itself on
11 key aspects of the agreed-upon terms in the MOU after it became aware of
12 the magnitude of the impacts of the summer 2000. Now Ms. Smith is using
13 APS' reversal to suggest that Citizens did not achieve these results,
14 implicitly suggesting that Citizens should have known what actions APS
15 would later take. Once again, this is a blatant use of hindsight on Ms.
16 Smith's part to assert that Citizens did not take reasonable actions at the
17 time. As Dr. Avera and Ms. Eckert testify, the events in the California
18 market and western electric markets had a severe impact. In the summer
19 of 2000, those events were tantamount to a devastating explosion that
20 caused chaos and extreme responses by market participants. As a result of
21 these events, APS chose to back away for the MOU. There was no
22 reasonable way for Citizens to have known at the time it signed the MOU
23 that APS would later take these actions.

24
25 Q. Do you agree with Ms. Smith's statements that Citizens should have
26 expected the high prices that occurred in the summer 2000 and therefore
27 anticipated APS' actions in response?
28
29

1 A. No. The fundamental issue here is magnitude. As Mr. Douglas Smith
2 admits in his surrebuttal testimony (page 7), it is not reasonable to expect
3 that Citizens should have known that western spot market prices would
4 turn out to be as high as occurred in summer 2000. He, however, points to
5 a few bits of select data indicating market prices may rise somewhat. APS
6 took aggressive actions in summer 2000 in reversing the commitments it
7 made. It did not do so because market prices were "somewhat" high; it did
8 so because of the extremity of the prices that actually occurred. To now
9 use hindsight to say Citizens should have anticipated that extreme
10 conditions would cause APS to take extreme actions is simply an
11 unreasonable position.
12

13 Q. On page 15 of her testimony, Ms. Smith suggests that the reason Schedule
14 A had not shown the minimum bill calculation prior to August 2000, is that
15 market prices may not have been high enough previously to make the
16 minimum bill provisions relevant. Do you agree with that assessment?

17 A. No. APS did not bill Schedule A using minimum bill calculations because in
18 Citizens' view, doing so had not occurred to APS before late summer 2000.
19 Whereas, APS consistently calculated both minimum and maximum charges
20 under Schedules B & C in monthly bills, prior to the revision of bills received
21 for May and June 2000 received in August 2000, APS have never even
22 calculated the minimum charges under Schedule A. Further, there is
23 empirical evidence that APS could have billed Schedule A under minimum
24 bill provisions (using its interpretation of summer 2000) as far back as
25 August 1998, but did not.
26
27
28
29

1 Q. What empirical evidence are you referring to?

2 A. The billing data provided on Schedule A can be used to back into APS'
3 incremental energy cost for serving the base load block. For example, for
4 the months of August 1998 and July 1999 through September 1999, it can
5 be shown that this calculated incremental cost is greater than the price
6 charged for the Schedule A base load block. Under APS new, aggressive
7 interpretation of Schedule A, these months would have been billed based
8 on the minimum bill procedures rather than the nominal charges that were
9 actually billed.

10

11 Q. How much of the \$70 million figure referenced by Ms. Smith is associated
12 with Schedule A?

13 A. Of that \$70 million, \$45.8 million is associated with Schedule A.

14

15 Q. On page 11 of her testimony, Ms. Smith states that the "presumption that
16 La Capra Associates had reviewed and approved Citizens' market price
17 forecast is simply not correct." Do you find that statement compelling?

18 A. No. On page 2 of Richard La Capra's July 1999 testimony in Citizens'
19 stranded cost proceeding, he states that one of the requirements for
20 effective electric competition is that "Disputes over stranded cost must be
21 resolved." Later he concludes that Citizens had taken action to resolve
22 disputes over its stranded costs, which included portions of the APS power
23 supply contract and the contract to build a combustion turbine facility in
24 Mohave County. Citizens had presented in Commission filings its
25 exhaustive analysis of western power markets that established the basis for
26 its projection of its stranded costs. It stretches credulity to now suggest, as
27 Ms. Smith has, that consideration was not given to Citizens' estimates of
28

28

29

1 stranded costs (and thus market prices) in its determination that Citizens'
2 proposals resolved disputes over stranded cost – one of Mr. La Capra's
3 stated goals.

4
5 Q. Later in testimony, Ms. Smith suggests that Citizens did not consider the
6 TEP and APS stranded cost cases, which in her view, involved "settlements
7 that were not dependent on projections of market prices." Do you find
8 those assertions compelling?

9 A. No. First of all, I did refer to the APS settlement on page 27 of my rebuttal
10 testimony. More importantly, to suggest that these settlements did not
11 require a projection of market prices ignores the very definition of stranded
12 costs. As part of the APS settlement, the parties agreed (page 5 of the
13 Settlement Agreement) that:

14
15 3.2. APS has demonstrated that its allowable stranded costs after
16 mitigation (which result from the impact of retail access), exclusive of
17 regulatory assets, are at least \$533 million net present value.

18 3.3. The Parties agree that APS should not be allowed to recover \$183
19 million net present value of the amounts included above. APS shall
20 have a reasonable opportunity to recover \$350 net present value
21 through a competitive transition charge ("CTC") set forth in Exhibit A
22 attached hereto...

23
24 While Staff was not a signatory to this Settlement Agreement, it did later
25 submit testimony supporting recovery of \$350 million by APS. Clearly, the
26 stranded cost projections in the APS proceeding were based on a projection
27 of market prices. By agreeing to recovery of a particular amount, Staff was
28 supporting APS' position that stranded costs would at least be that much,
29

1 thus implicitly accepting a particular level of market prices. It stretches
2 credulity for Ms. Smith, who was advising Staff at the time on this matter,
3 to state that she "did not make any projections [of market prices] for the
4 year 2000 or beyond," when she was supporting the recovery of a
5 particular level of stranded costs.

6
7 Q. What incorrect statements does Ms. Smith make relative to the Valencia
8 facilities?

9 A. Ms. Smith makes several incorrect statements in this regard. First, she
10 suggests that it is **new** information presented in my rebuttal testimony
11 about the scope of the improvements made to the Valencia facility. In fact
12 the information included in my rebuttal testimony, paraphrased by Ms.
13 Smith on page 13 of her surrebuttal testimony, was previously provided to
14 Staff in response to RUCO Data Request 4.4, a copy of which is attached to
15 my rejoinder testimony. Second, Ms. Smith incorrectly states that Citizens
16 recovers operating and maintenance ("O&M") costs through the PPFAC
17 bank. While it is true that Citizens would seek recovery of a normal level of
18 O&M costs through base rates in a general rate case, it does not recover
19 those costs via the PPFAC mechanism. Relative to the Valencia facilities,
20 only fuel costs are recovered through the PPFAC. Finally, Ms. Smith
21 suggests that Citizens would in effect pay twice for power (first, for the fuel
22 and O&M costs of running the units and second, for the energy charge
23 under the new contract) whenever APS called for economic operation of the
24 units. This is incorrect. Citizens would incur fuel and O&M costs when the
25 Valencia units were dispatched for economic purposes by APS, but would
26 not also pay energy charges under the power supply contract for the power
27 generated, as Ms. Smith suggests.

1 **SURREBUTTAL TESTIMONY OF RICHARD ROSEN**

2 Q. Dr. Rosen concludes in the first of the four points he makes at the opening
3 of his surrebuttal testimony that Citizens should have filed a complaint with
4 FERC to determine the correct contract interpretation "in or about May
5 1999." Does this conclusion have merit?

6 A. No. May 1999 was the month in which Citizens received the APS billing
7 adjustment, which prompted an investigation by Citizens into APS' billing
8 procedures. Since Citizens was only beginning its investigation at that
9 time, it certainly had no basis for filing a complaint in May 1999.

10
11 Q. Dr. Rosen points out that May 1999 was the time period when Citizens
12 "became aware of a second pricing dispute while it was negotiating a
13 resolution to its first pricing dispute." Does the fact that there were then
14 two simultaneous disputes somehow add support to the notion that Citizens
15 should have filed a complaint at that point?

16 A. No, not at all. The first and second disputes were not related at all. The
17 first dispute developed as a result of Citizens' investigation into APS'
18 *embedded* cost of service and led to a reduction in Schedule A pricing. The
19 second dispute was triggered by the May 1999 APS billing adjustment and
20 concerned APS' *incremental* generation costs. Dr. Rosen seems to imply
21 that, as soon as Citizens received word on the billing adjustment, somehow
22 Citizens had an immediate basis for moving forward with a complaint
23 because it had engaged APS in another contract matter. That is simply not
24 true.

1 Q. Dr. Rosen goes on to speculate that filing a FERC complaint "would have
2 pressured APS into more quickly negotiating a more comprehensive fix for
3 the contract language, or it would have likely resulted in a decision by FERC
4 before the summer of 2000..." Do you find these statements compelling?

5 A. No. Setting aside the fact that it was not practical for Citizens to file a
6 complaint in that time frame, Dr. Rosen is simply speculating about "what
7 might have happened if," using the benefit of hindsight to do so. The
8 implication is that, because Citizens did not take the specific steps that Dr.
9 Rosen now believes in hindsight it should have, Citizens was imprudent.
10 That, quite frankly, is nonsense. Citizens took the actions that I have
11 described above and in previous testimony because it believed those
12 actions to be proper given the information available to it at the time.
13 Citizens described in detail, in particular through the rebuttal and rejoinder
14 testimony of Mr. Flynn, why it did not file a FERC complaint in this matter.
15 Dr. Rosen does not even attempt to rebut those reasons he simply
16 continues to assert that Citizens should have made a filing.

17
18 Q. Dr. Rosen goes on to say that Citizens did not keep the interests of
19 ratepayers in mind because Citizens knew that it would recover the money
20 back from ratepayers..." Do you agree with those conclusions?

21 A. Absolutely not. Those statements are complete nonsense. Citizens clearly
22 understands its obligations to reasonably and prudently manage power
23 supply on its customers' behalf and has a demonstrated record of doing so.
24 Citizens also understands the consequences of not doing so. The record of
25 this proceeding is replete with the extensive actions that Citizens has taken
26 to reduce power costs in order to meet its obligations. Dr. Rosen takes a
27 portion of my rebuttal testimony out of context (page 16, lines 21 - 23) to
28 support his assertion that Citizens did not take actions to save money for
29

1 ratepayers and states that my testimony is "deceptive because during the
2 years of litigation customers would not be impacted by high costs." First,
3 that position incorrectly assumes that the Commission would have taken no
4 action throughout this entire period to pass through charges incurred
5 through the procedure it has approved. What Dr. Rosen also fails to
6 consider is, that if after years of litigation Citizens loses its case, the much
7 greater power costs that did accumulate during those years would, in fact,
8 be even higher costs that customers would have to bear.

9
10 Q. On page 8 of his surrebuttal testimony, Dr. Rosen states that Citizens
11 "biased its analysis of the likely cost savings under the new contract for the
12 summer 2001." Do you agree?

13 A. No. Bias suggests an intent to mislead and it is ridiculous to suggest that I
14 had any such intent in developing the estimate of savings. The
15 assumptions under which the estimate was done were clearly described in
16 my direct testimony. It was probable that summer 2001 billing would have
17 been based on APS' hedged power costs, similar to those experienced in
18 May 2001, and accordingly I based the estimate on May 2001 costs to
19 explain the immediate benefits of the New Contract.

20
21 Q. On page 12 of his testimony Dr. Rosen suggests that there was no
22 immediacy associated with Citizens executing a new contract with APS for
23 the summer of 2001. Do you agree?

24 A. No, not at all. During the June through September period, Citizens'
25 customers use over 40% of their total annual requirements and do so when
26 prices are at their highest level for the year. The immediacy of entering a
27 new contract was created by the need to avoid high summer 2001 charges
28 that would be borne by Citizens' customers. To suggest that Citizens "could
29

1 have taken another few months, at least, to carefully assess the likely
2 future behavior of the Western power market" is an interesting use of
3 hindsight, but nothing more than that. Citizens took the prudent steps of
4 re-negotiating a new contract with the lowest possible pricing it could
5 achieve and getting the new contract in place prior to the highest cost
6 period of the year. The fact that certain parties may have been criticizing
7 California for the actions it took does not change the fact that Citizens was
8 facing its highest-use season with no certainty about how market prices
9 would be. Instead of gambling that prices would fall, Citizens took the
10 prudent action of protecting its customers from the volatility of electric
11 market prices through the New Contract.

12
13 Q. On page 13 of his surrebuttal testimony, Dr. Rosen discusses the
14 probability of the combination of three types of events occurring
15 simultaneously in the future. Do you have a response to this discussion?

16 A. Yes. Dr. Rosen attempts to provide reasons why the new APS contract will
17 likely be at a higher cost than the Old Contract by asserting that the New
18 Contract could only be lower cost under what he says is an improbable
19 outcome of three events occurring simultaneously:

- 20 1. Wholesale market prices at Palo Verde hub rise substantially;
- 21 2. Citizens interpretation of the contract is determined to be wrong; and
- 22 3. APS remains resource short.

23 This is not the least bit compelling. First, Dr. Rosen's scenario might be
24 more compelling if the occurrence of one of these events presaged the
25 occurrence of one or another of the other two, but they are completely
26 unrelated events. Second, Citizens has done an in-depth legal analysis of
27 its likelihood of prevailing on its interpretation of the contract and, as Mr.
28 Flynn describes in his rebuttal and rejoinder testimony, determined that it
29

1 did not have a reasonable chance of winning. Third, given the deregulation
2 of both wholesale and retail electric transactions, APS still faces great
3 uncertainty about its ability to recover generation costs going into the
4 future. Given this uncertainty, there is little support for the notion that APS
5 would make the decision to cover its total load with firm obligations. The
6 proper analysis here is: given the likelihood that Citizens would not prevail
7 in its interpretation of the contract and that APS would likely remain
8 resource short, is it reasonable to remain subject to the potential that
9 wholesale market prices may rise substantially again in the future? In
10 Citizens' view, the answer to this was and is clearly "no". The supporting
11 statements in Dr. Rosen's scenario suggest that the Commission could
12 review APS' supply planning and somehow force APS to cover its total retail
13 and wholesale load with firm resources. This is not correct. First, the
14 Commission has suspended its resource planning rules as they apply to
15 power supply planning. Second, the Commission does not have jurisdiction
16 over wholesale transactions. Consequently, what Dr. Rosen suggests
17 simply has no merit.

18
19 Q. Does this conclude your rejoinder testimony?

20 A. Yes, it does.

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25
26
27 H:\Deb~docs\PPFAC\Testimony\SRB Rejoinder~Final.DOC

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

Witness: Sean Breen

Data Request No. LS 5.11:

Please provide any memos, reports, letters, e-mails, or other documents from Citizens personnel or legal counsel or others regarding the interpretation of the System Incremental Cost in Schedules A, B, or C of the contract in force prior to May of 2000.

Response:

Citizens objects to the request for work product from legal counsel, because Staff is seeking confidential information that is protected by the attorney-client privilege and the work product privilege. Please see the attached letters: 1) March 23, 2000 letter to Jack Davis of APS/PWEC; 2) April 17, 2000 letter to Daniel McCarthy of Citizens; and 3) April 24, 2000 letter to Jack Davis. These letters are not confidential and address the interpretation of System Incremental Cost in the former Power Service Agreement and its Service Schedules.

A Citizens Energy Service Company
1300 South Yale Street
Flagstaff, AZ 86001
520.774.4592



March 23, 2000

Mr. Jack Davis
President
Arizona Public Service Company
400 N. 5th St.
Mail Station 9080
PO Box 53999
Phoenix, Arizona 85072-3999

Dear Mr. Davis,

I am writing to you to address a significant matter concerning the power supply agreements under which Citizens purchases virtually all its capacity and energy requirements from APS. Citizens has determined that errors in APS' billing practices have resulted in over-charges to Citizens, potentially for the last several years, in amounts that may well have reached several million dollars. I recognize that both of our companies are at crossroads, with significant changes in our operations looming in the near-term future, and would like to settle this matter as quickly as possible so that it does not disrupt either of our plans to move forward. This letter provides background on this contract matter and seeks your help in reaching a speedy resolution.

As you may know, Citizens and APS have been discussing various matters concerning the Power Service Agreement ("Agreement") over the last several months. In particular, in a July 22, 1999 letter to Dennis Beals, Citizens alerted APS that it did not accept the validity of the revised billing received in May 1999, and indicated its interest in continuing to work with APS to clarify the inputs and calculation procedures behind the billing process under the Agreement. This review process involved a number of meetings and the exchange of various information and proposals. Moreover, in January of this year, Citizens received a letter from Mr. Beals proposing the implementation of a "hold-harmless" provision in the Agreement to address potential FERC requirements in connection with APS' corporate restructuring. While this matter is not directly related to the first, it raises concerns that must be addressed. Both of these matters concern the definition in the Agreement of "APS' System Incremental Cost (SIC)" that is used to

derive Citizens' energy pricing. The resolution of both issues requires a clear understanding of the SIC provision of the Agreement and the intent of the parties in negotiating the SIC language.

Citizens has undertaken an extensive review of these matters and has consulted with those individuals who were directly responsible for drafting and negotiating the original contracts in which the SIC concept was first developed. Based on this review and our discussions over the last several months, Citizens has concluded that, for a yet-to-be determined period of time (possibly since January 1995), APS has mis-applied the SIC definition in the Agreement and made errors with respect to billed energy charges to Citizens. The following addresses the basis for this conclusion, the changes in calculation procedures that APS must implement to properly meet the Agreement requirements, and the remedy Citizens is due as a result of past erroneous billings. I also address why APS' proposal for implementation of the hold-harmless provision is unacceptable.

Citizens' review of the issues that were paramount in the negotiations around the Agreement revealed a number of principles on which the SIC definition was to be based, some of which are summarized below:

- 1. The inclusion of "economic" purchased power in the derivation of SIC was intended to lower Citizens' energy costs.** Citizens' understanding, and APS' representation, was that APS from time-to-time would purchase power for economic purposes in lieu of dispatching its own higher cost generation. In the event that such purchases occurred simultaneously with sales to Citizens, and would not otherwise be needed to effect transactions under the Agreement, Citizens would receive the benefit of these economic purchases. It is evident that APS is reflecting power purchases made for other reasons (e.g. reliability purchases) in its billing to Citizens, which is in clear contradiction to the language and intent of the Agreement.
- 2. The inclusion of the requirement that purchased power was to be "simultaneous with sales to Citizens..." in the SIC definition was intended as protection for Citizens from being charged for all energy deliveries at a price equal to the single highest-cost purchase when additional lower cost resources were available and could contribute to**

serving Citizens' load. Recent APS proposals have acknowledged this point and indicated that APS would stop pricing all Citizens deliveries at the level of the highest-cost purchase, regardless of the size of the purchase.

3. **Under the SIC definition, economic purchases do not include purchases made in anticipation of high market prices where actual prices realized were in fact lower.** The only includable purchases were those that were in fact economic purchases, which would require them to be the least-cost alternative at the time of the purchase. Based on Citizens' review of APS billing practice, APS has not adhered to this principle.
4. **As had been included in past agreements after extensive negotiations, purchased power transactions used in the SIC derivation were to be cost-based, energy-only transactions (possibly adjusted only for de minimis administrative mark-ups allowed by FERC) that did not include any demand-related costs or other market considerations.** It appears that APS is including in the SIC calculations firm purchases made on the open market that are not cost-based and which include both demand and energy charges as well as potentially other market considerations. This is in contradiction to the intent of the Agreement.

In his November 3, 1993 letter to Citizens' Vice President (copy attached), Greg Stamp of APS describes, in connection with then-current power supply negotiations, an SIC calculation method reflecting the outcome of discussions with Citizens. These discussions were part of an ongoing dialogue between Citizens and APS and extended into the negotiations leading to the present Agreements. Accordingly, the SIC calculation described in the Stamp letter reflects Citizens' understanding of the principles to be employed under the Agreement. A notable difference between the specifics described in the Stamp letter and the present Agreement is that the economic dispatch for calculating SIC would apply only to APS' native load plus Citizens load (not including off-system sales). Consistent with this explanation and with the above principles, APS must conform its SIC calculation method to the bargained-for terms of the Agreement. Specifically, APS must:

- implement an economic dispatch approach to SIC calculation consistent with the November 3, 1993 Stamp letter based on APS native load plus Citizens' load (not including off-system sales);
- include all generating units deemed available and employ least-cost optimization principles in the SIC calculation (e.g. consideration of generation start-up and part-load costs in purchase decisions);
- remove all purchased power transactions from the calculation that are not least-cost alternatives to APS' generation resources;
- do not include competitive marketplace purchases directly in the calculation, and instead create a proxy for these purchases that reflect the economic equivalent of a traditional, energy-only, cost-of-service pricing; and
- include only purchased power transactions that are determined after-the-fact to be least-cost alternatives.

In Citizens' view, this methodology, and the principles outlined above, are consistent with the bargained-for provisions embodied in the Agreement, and if properly employed would have resulted in significantly lower energy billing to Citizens. Citizens is entitled to a full refund of all over-billed amounts, with interest dating back to the time the erroneous billing practices began. However, it is not clear for how long APS has been erroneously billing Citizens under the Agreement, and, moreover, based on our discussions, it is unclear whether APS has retained the data necessary to conduct a calculation consistent with the foregoing. In the event that APS, for lack of data, cannot correct its billing errors, Citizens is willing to enter negotiations with APS for the purpose of reaching a negotiated settlement to these issues.

Citizens notes that the event that brought this matter to our attention was the revised billing adjustment totaling approximately \$4.3 million submitted by APS for the 11-month period beginning January 1998 and paid by Citizens. After careful consideration of the position put forth by APS, a review of the documentation prepared by APS, and a review of the Agreement, Citizens realized that the methodology employed by APS was not in conformance with the Agreement. Citizens understands that the sole reason that APS decided to make the adjustment was the omission of economic purchased power costs from the SIC calculation in APS' billing routine for Citizens, which should have resulted in lowering the costs, not increasing the costs.

Accordingly, Citizens believes it is reasonably due, at minimum, a refund of the entire \$4.3 million adjustment for the 1998 billing period. For similar reasons, Citizens is also entitled to a refund to 1999 and 2000 billings and to years prior to 1998. Citizens has not yet completed an in-depth analysis of billings during these periods; however, not knowing when APS started billing Citizens using flawed procedures, we believe it is reasonable to assume APS has been computing Citizens' bills incorrectly since the January 1995 implementation of the current Agreement. It is probable that billing errors of comparable magnitude occurred since the very beginning of the Agreement. Consequently, Citizens expects that further analysis will show that refunds totaling several million dollars are in fact due from APS.

Citizens regards this as a matter of high priority, and we encourage APS to cooperate in seeking an expeditious resolution. Absent such efforts, Citizens' only recourse is to bring this matter to the attention of regulatory authorities, an action that it hopes is not necessary.

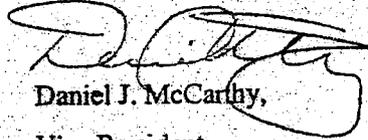
Finally, Mr. Beals' letter of January 24 regarding APS' corporate restructuring activities presents a proposal for a hold-harmless provision in the Agreement that effectively caps energy charges based on Palo Verde energy trading prices. As indicated above, one of the errors made in deriving the SIC for Citizens' billing has been to regard the "energy" prices in the competitive marketplace as proxies for the energy pricing under the Agreement. This is clearly an erroneous assumption given that the competitive energy products are for firm energy deliveries at a \$/MWh price that includes capacity costs. The present Agreement contemplates pricing based on traditional, cost-of-service approaches with energy pricing based solely on variable, energy-only related costs. Citizens has entered into the existing Agreement with the express understanding that it would be carried out under these rate making principles that are fully regulated by the FERC. The proposed price-cap mechanism is inconsistent with this requirement and is therefore not acceptable to Citizens.

I have instructed Sean Breen to make these matters his highest priority and would ask that you or your designee contact him or me at the earliest possible time to seek a mutually acceptable resolution to these matters. Thank you for your prompt attention to this matter.

Mr. Jack Davis

March 23, 2000

Sincerely,

A handwritten signature in black ink, appearing to read "Daniel J. McCarthy", written over a horizontal line.

Daniel J. McCarthy,

Vice President.

Attachment

cc: Dennis Beals
Sean Breen

NOV 2 - 1993

Arizona Public Service Company

P.O. BOX 53999 • PHOENIX, ARIZONA 85072-3999

November 1, 1993

Mr. James P. Avery
Vice President, Electric Operations
Citizens Utilities Company
High Ridge Park
Stamford, CT 06905

Dear Jim:

Enclosed is the revised draft of the Non-Firm Energy Agreement, dated 11/1/93, for your review. Please note in Section 7, the criteria for interruptions of Non-Firm Energy has been added. Based on prior experience, APS feels that the Non-Firm Energy could be interrupted in the order of 20 times per year for unlimited duration.

APS' responses to requests regarding the 09/28/93 Non-Firm Energy Agreement ("Agreement") draft that was provided to you for comments are as follows:

1. Revise Section 19, APPROVALS, in the Agreement to reflect that if FERC accepts all of the Agreements terms and conditions, rates and charges, except those in Section A.3, Monthly Regulating Charge, APS will make an attempt through an amendment to its filing to develop a new concept or methodology for implementing a regulating charge that will be acceptable to FERC.

Section 19 has been revised. See Section 19.2.

2. Provide an explanation of how APS would determine APS' Hourly Incremental Energy Cost, as defined in Section 4.1 of the Agreement.

APS' Hourly Incremental Energy Cost will be determined by APS performing two (2) calculations at the end of each month for each hour during the month. These calculations will include among others; actual hourly system load, actual fuel costs, current generating unit heat rates, actual generating unit availability and actual purchase power costs. The first calculation will simulate the actual commitment and loading of generating units and purchased power to meet APS' total load requirements (including off system sales), including APS providing Citizens Non-Firm Energy and the second would simulate the most economical commitment and loading of generating units and purchase power to meet APS' total load requirements (including off-system sales), without APS providing Citizens Non-Firm Energy. The resulting cost difference will represent APS' Hourly Incremental Energy Cost.

Jim, call me if you have any comments regarding the above.

Sincerely,



Greg Stamp
Power Contracts Analyst

cc: Steve Binkley



Jack Davis
President
Energy Delivery and Sales

TEL 602/250-3529
FAX 602/250-3002

Mail Station 9080
P.O. Box 53999
Phoenix, AZ 85072-3999

April 17, 2000

Daniel J. McCarthy
Vice President
Citizens Energy Service Company
100 South Yale Street
Flagstaff, AZ 86001

Dear Mr. McCarthy:

I have received your letter dated March 23, 2000, in which you express concerns with respect to the System Incremental Cost ("SIC") provisions contained in the Power Service Agreement between Arizona Public Service Company and Citizens. APS values its business relationship with Citizens and wants to address directly any concerns Citizens has with respect to our dealings with each other. We have carefully reviewed the concerns and issues raised in your letter and address the major ones below. We would also like to meet with you at the earliest opportunity to discuss and resolve these and any other issues you may have.

Generally, the positions taken in your letter appear to reflect a misunderstanding of the contractual relationship between the parties. First, Citizens' reliance on a November 3, 1993 letter from Greg Stamp is misplaced. As Mr. Stamp confirmed in a letter dated July 13, 1994 (a copy of which is enclosed), the November 1993 proposal was withdrawn and deemed to be "null and void." Also, the nature of that proposal—for a "Non-Firm Energy Agreement"—was completely different from the firm energy products that are the subject of the service schedules at issue in your letter.

Second, the SIC provisions do not impact all services provided by APS to Citizens under the Agreement. For example, the pricing for Service Schedule A Base Block and Service Schedule C services are not based on the SIC provisions.

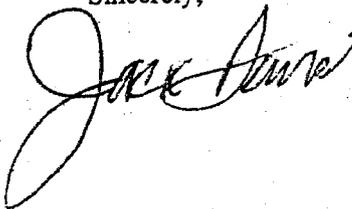
Third, APS has properly billed Citizens under the SIC provisions. Citizens' place in the APS resource stack is at the top of APS' native load requirements. When APS purchases power and energy to meet its requirements, including Citizens, Citizens is obligated to pay the incremental costs. Contrary to your suggestion, nothing in the SIC provisions in the Agreement limits Citizens' obligation to only those purchases that back down APS generation. As indicated by your reference to Mr. Stamp's letter in 1993, it would have been easy for the parties to limit Citizens' system incremental cost obligation as you suggest, but such language was not included in the Agreement and therefore cannot have been the intent of the parties. APS has consistently applied the SIC provisions as set forth in the Agreement. Even when computer issues in 1998 prevented APS from fully calculating SIC and purchased power expenses, APS informed Citizens that such billing would take place when the problems were fixed.

April 17, 2000
Daniel J. McCarthy
Page 2

That said, we would like to meet with you to go over your concerns. We generally believe that parties should attempt to resolve issues themselves, without incurring unnecessary and unplanned litigation expenses before regulatory agencies or the courts. That is particularly true here, where FERC is unlikely to become involved because the rates on file are maximum and minimum charges, and where the courts are unlikely to have the necessary understanding of utility operations and pricing to achieve a reasonable result. As you know, we have offered compromises on certain of these issues in the past, and we are willing to take another look at those offers and to look for other ways to resolve the issues between us.

Toward that end, I have arranged to make our team available to meet anytime this week, preferably on Wednesday, April 19. We would propose that the parties sit down together and resolve these issues without further delay. Please contact my secretary at (602) 250-3444 to make the necessary arrangements.

Sincerely,

A handwritten signature in cursive script, appearing to read "Jack Stone". The signature is written in dark ink and is positioned below the word "Sincerely,".

JD/JM/BC/ldm

Enclosure

A Citizens Energy Service Company
1300 South Yale Street
Flagstaff, AZ 86001
520.774.4592



April 24, 2000

Mr. Jack Davis
President
Arizona Public Service Company
400 N. 5th St.
Mail Station 9080
PO Box 53999
Phoenix, Arizona 85072-3999

Dear Mr. Davis:

I have received your letter dated April 17, 2000 responding to Citizens' concerns with billings under the Power Service Agreement ("Agreement") and conclude that there remains considerable disagreement between our companies. Further, I have been advised of a letter from Dennis Beals, dated April 17, 2000, that summarizes the provisions of an upcoming FERC filing by Pinnacle West Corporation. For the reasons also set forth in my March 23rd letter, Citizens does not support the proposal in Mr. Beals' letter for capping SIC prices. Members of Citizens' negotiating team have arranged to meet with APS personnel later this week to discuss the issues and determine whether resolution appears possible.

I have instructed the Citizens' team to address, in addition to the other points in my March 23rd letter, the following areas of apparent disagreement:

1. November 1993 Greg Stamp Letter – My March 23rd letter stated that the SIC calculation method described in Mr. Stamp's letter reflected Citizens' understanding of the principles to be employed under the Agreement. Citizens disagrees with the characterization in your letter of Citizens' reliance on that communication as being "misplaced." With the exception of the exclusion of off-system sales as noted in my letter, the Stamp letter accurately describes Citizens' and APS' understanding of how the calculation of System Incremental Cost in the current Agreement would be done. The fact that the proposal for the "Non-Firm Energy Agreement," then under discussion, was later withdrawn for other reasons does not change this understanding.
2. Service Schedule C Pricing – Your letter states that Schedule C services are not based on SIC provisions. In fact, as set forth in Exhibit A, the Schedule C energy charges from APS generation are based on SIC with a mark-up of 10% of SIC. If SIC for an hour is based on purchased power the 10% mark up is limited to one mill/kWh.

3. SIC Billing – Citizens may agree that its place in the APS resource stack is at the top of native load requirements. However, for reasons set forth in my March 23rd letter, APS is improperly pricing the incremental power to meet Citizens' load. Moreover, Citizens disagrees with the statement in your letter that the Agreement does not limit Citizens' obligations to only those purchases that back down APS generation. As you know, the agreements define System Incremental Cost that can be recovered under the agreements from Citizens as:

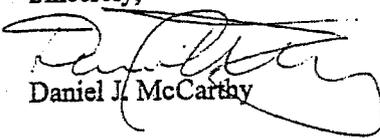
"The higher of either the incremental fuel cost of the station or unit for which energy is obtained, *estimated over the applicable rate of output dispatched*; or the cost of any purchased power occurring simultaneously with sales under this Service Agreement which were made for *economic purposes and would not otherwise be needed to effect transactions under the Service Agreement*, plus ... start-up ... [and]... other incremental costs." [emphasis added]

The inclusion in the SIC definition of the qualifying phrase "which were made for economic purposes and would not otherwise be needed to affect transactions under this Agreement" specifically limits the purchases chargeable to Citizens and directly contradicts your interpretation. Moreover, it appears to have been APS' practice to charge Citizens the highest cost purchase for Citizens' entire load in an hour, even if the purchase was for only a fraction of the Citizens' load. These issues are in dispute only because APS ignores or places no meaning to the italicized words in the definition of System Incremental Costs above.

4. FERC Jurisdiction – Citizens also disagrees with the suggestion that FERC is unlikely to become involved with a complaint in this matter because the rates on file are maximum and minimum charges. While FERC has approved the rates charged under the Agreement subject to a floor and a ceiling, it is the rates in the agreements that are the rates on file and the rates that are the subject of the dispute. This is squarely a case in which APS has miscalculated the rates approved by FERC and on file with FERC. FERC is the appropriate body to resolve this dispute.

The Citizens' negotiating team looks forward to addressing the above points at the upcoming meeting. I was pleased to hear of your willingness to discuss alternative ways to resolve the issues between us, and I am hopeful that the outcome of this meeting will narrow these issues and allow for a speedy resolution of this matter. Absent meaningful progress, Citizens has little choice but to pursue its remedies.

Sincerely,


Daniel J. McCarthy

**CITIZENS COMMUNICATIONS COMPANY
ARIZONA ELECTRIC DIVISION'S RESPONSES TO THE
RESIDENTIAL UTILITY CONSUMER'S OFFICE
FOURTH SET OF DATA REQUESTS
DOCKET NO. E-01032C-00-0751
October 9, 2001**

Data Request No. 4.4:

Please describe all the efforts Citizens was engaged in to mitigate the dramatic increase in power costs to AED customers.

Respondent: Sean Breen

Response:

The principle actions taken by the AED to avoid the unprecedented summer 2000 price levels during the following summer were the installation of enhancements to the Valencia Power Plant to enable it to be used to offset a portion of high power charges from APS, and the initiation of the "Voluntary Curtailment Program", a new demand-side management ("DSM") effort.

Valencia Power Plant

The Valencia Power Plant has served principally as an emergency backup to the single radial transmission line importing power into the Santa Cruz Electric Division. This plant also provided capacity credits under the former Power Service Agreement ("PSA") with APS. Following the unprecedented high power prices experienced in the summer 2000, the AED explored the possibility of improving and modifying the plant so it could generate power to serve the local load when prices under the APS contract exceeded the cost to operate the generators.

From the fall of 2000 until spring of 2001, the AED implemented a number of changes and enhancements to prepare the plant to operate in a load-serving mode, including:

- Running performance tests on the machine governor and control system;
- Replacing breakers at the Valencia Substation;
- Undertaking a stability study investigating the operation of the generators while serving load;
- Updating the turbine control system;
- Installing a continuous emissions monitoring system;
- Seeking an amendment to its Air Quality Permit;

**CITIZENS COMMUNICATIONS COMPANY
ARIZONA ELECTRIC DIVISION'S RESPONSES TO THE
RESIDENTIAL UTILITY CONSUMER'S OFFICE
FOURTH SET OF DATA REQUESTS
DOCKET NO. E-01032C-00-0751
October 9, 2001**

Response to Data Request No. 4.4 Cont:

- Overhauling key components of the machines;
- Making arrangements for additional fuel supplies; and
- Making arrangements with APS to receive regular updates on the expected cost of power for serving AED load.

With these preparations in place, in May 2001 the AED began to operate the Valencia turbines to avoid high power charges from APS. In that month alone, the AED estimates that it achieved net savings of approximately \$900,000 in power supply costs. As a result of negotiating the current low, fixed-rate contract with APS/PWCC, the Valencia turbines are no longer needed to serve local load to mitigate high power costs.

Voluntary Curtailment Plan

Following the summer 2000 power cost increases, the AED undertook a number of DSM initiatives to enlist customers' participation in the effort to mitigate power costs. The primary effort was the development of a new load-management initiative, called the Voluntary Curtailment Program ("VCP"). The VCP allowed qualifying customers the opportunity to curtail their load during times of high-energy costs, in return for bill credits based on AED's avoided costs. Under the VCP, customers could curtail load by shutting down, rescheduling operations, using backup generating equipment, or conserving energy usage. In May 2001, the AED received Commission approval for a voluntary service curtailment tariff rider for its largest commercial power customers. Following this approval, final implementation details for the VCP were undertaken, including:

- Customer enlistment;
- Baseline load metering;
- Arrangements for day-ahead, hourly pricing information from APS; and
- Web site posting of curtailment prices.

Because Citizens' avoided costs under the new contract are so much lower than the former contract the economic circumstances that supported the VCP no longer exist. This is because with the new lower rates, customers no longer have an economic incentive to curtail their energy use.

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**REJOINDER TESTIMONY
OF
PAUL M. FLYNN**

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**CONSULTANT FOR
CITIZENS COMMUNICATIONS COMPANY
ARIZONA ELECTRIC DIVISION**

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DOCKET NO. E-01032C-00-0751

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MARCH 19, 2002

1 Q. Please state your name and business address.

2 A. My name is Paul M. Flynn. My business address is Wright & Talisman, P.C.,
3 Suite 600, 1200 G Street, N.W., Wahington, D.C.

4
5 Q. Are you the same Paul M. Flynn that submitted rebuttal testimony in this
6 proceeding?

7 A. Yes, I am.

8
9 Q. What is the purpose of your rejoinder testimony in this proceeding?

10 A. My rejoinder testimony responds to the Surrebuttal Testimony submitted by
11 Ms. Lee Smith on behalf of the Arizona Corporation Commission Staff and
12 the Surrebuttal Testimony of Dr. Richard A. Rosen submitted on behalf of
13 the Arizona Residential Utility Consumer Office. Specifically, I address their
14 assertions that, notwithstanding that Citizens was advised by counsel that
15 the prospects for success from FERC or court litigation on Citizens' power
16 supply contract were not good, Citizens' decision not to institute such
17 litigation is imprudent.

18
19 Q. Can you place this issue in context?

20 A. My understanding of the context of this proceeding is that Citizens is
21 entitled to recover the costs it paid for power that was needed to provide
22 service to its customers unless the amount sought to be recovered is
23 excessive due to imprudence or abuse. No party alleges that Citizens
24 engaged in abuse. My general understanding of the standard before this
25 Commission for denial of cost recovery on grounds of imprudence is that it
26 is somewhat similar to the standard before the FERC. In fact, based on my
27 review of the Commission rule on "prudently invested" – a closely related
28 concept, this Commission appears to strongly disfavor imprudence

29

1 allegations. But, in any event, the regulator must assess whether the
2 utility acted reasonably based on the facts that management knew or
3 reasonably should have known at the time. However, the regulator will not
4 substitute its judgment for that of the utility manager. If management
5 chose a course that was reasonable at the time, it is not considered
6 imprudent merely because it could have reasonably chosen other courses.
7 Nor is it imprudent if an action that seemed reasonable at the time
8 (considering all the facts then known) ultimately led to higher costs.

9
10 This summary is not intended to substitute for, or to prejudice, the legal
11 arguments Citizens will present in this case. Instead, my only purpose is to
12 set in general terms the context, as I understand it, for assessing the
13 positions maintained by Ms. Smith and Dr. Rosen in their rejoinder
14 testimony about what Citizens should or should not have done with respect
15 to its supply contract.

16
17 Q. Please place your rebuttal testimony in this context.

18 A. In my rebuttal testimony, I explained that Citizens consulted my firm,
19 Wright & Talisman, P.C., which has extensive experience representing
20 clients before FERC and in commercial litigation, for advice on its dispute
21 with Arizona Public Service Company ("APS") over their power supply
22 agreement ("PSA", also referred to as the "Old Contract"). I testified that
23 although we initially concluded that Citizens might have a better than even
24 chance of success in a civil contract breach suit, we ultimately concluded,
25 based on further analysis, that Citizens' chances of success were
26 substantially lower than that, and that I so advised Citizens. Based in part
27 on this advice, and to avoid high billings under the PSA that Citizens
28 anticipated would continue, Citizens chose not to litigate and instead

1 negotiated a new power supply agreement with APS' affiliate, Pinnacle West
2 Capital Corporation. Therefore, Citizens gave very careful consideration to
3 the initiation of litigation over the PSA at FERC or the courts, but ultimately
4 concluded, based on expert advice, that litigation would not be an effective
5 course of action to protect itself and its ratepayers from high costs under
6 the PSA.

7
8 Q. Turning now to the specific points raised in the surrebuttal testimony, Ms.
9 Smith argues (at page 5) that the fact that Citizens was advised that it was
10 likely to lose the central contract interpretation issue in the case should not
11 have deterred Citizens from filing a complaint, because even if Citizens lost,
12 it would not have left Citizens worse off. Is this a valid basis for concluding
13 that Citizens' conduct was unreasonable?

14 A. No. First, the "no worse off" argument is itself groundless. If Citizens had
15 unsuccessfully pressed its theories on the Old Contract, an adverse decision
16 would have left APS with absolutely no reason to renegotiate a contract
17 that extended for ten more years. Second, it is perfectly reasonable for a
18 company to decide not to embark on major litigation if it reasonably
19 believes it is likely to lose. I would not counsel a company to initiate major
20 commercial litigation without a good likelihood of success. I certainly would
21 not counsel a client to initiate a major contract suit without a good
22 likelihood of success simply on the theory that an adverse decision on
23 interpretation of the contract would leave it no worse off. Simply put, a
24 prudent company does not file lawsuits it expects to lose.

1 Q. Ms. Smith also asserts (at pages 5-6) that if Citizens had filed a complaint
2 at FERC or the courts, even though Citizens was advised that such a
3 complaint was not likely to succeed, the complaint would be a "bargaining
4 chip" that would have induced APS to give more to Citizens in the
5 negotiations. Is this a basis for concluding that Citizens' conduct was
6 unreasonable?

7 A. No. Whether the filing of a lawsuit induces the defendant to grant the
8 plaintiff more advantageous terms in negotiations depends on the
9 defendant's view of the merit of the lawsuit. In this instance, Ms. Smith has
10 presented no evidence as to the merits of the complaint she urges Citizens
11 to file, so her assertion that it would have a beneficial effect on negotiations
12 is mere speculation, without any foundation. In contrast, I have testified
13 that my firm extensively analyzed the merit of a possible FERC complaint or
14 court action and advised Citizens that the prospects for success were not
15 good. Notably, the demand letter that Citizens presented to APS in March
16 2001, threatening litigation, produced a relatively sanguine response from
17 APS, as seen in the letter included with Ms. Smith's rebuttal testimony. In
18 fact, Mr. Davis makes it clear that as soon as Citizens merely threatened
19 "an offensive posture" it foreclosed any attempt to reach a negotiated
20 settlement. Moreover, APS has capable FERC counsel, and they could have
21 come to the same conclusion that we did, i.e., that the SIC provisions of
22 the PSA probably would have been enforced in a manner consistent with
23 APS' interpretation.

1 Q. Would the filing of a complaint have had an adverse effect on a negotiated
2 resolution of the dispute?

3 A. As I just discussed, a complaint probably would have delayed serious
4 negotiations. When a complaint is filed, a respondent's initial focus is on
5 mounting the strongest possible defense, partly to counter any negotiating
6 leverage that a complainant hopes to gain through its filing. If the merits
7 are not compelling and the respondent is not otherwise strongly motivated
8 to settle, the most likely development is that serious negotiations are
9 sidelined while the parties strengthen their litigation positions.

10

11 Q. Did that present problems for Citizens in this case?

12 A. Yes. Citizens was seriously concerned in the spring of 2001 about the
13 prospect of a repeat of the experience of the summer of 2000. As
14 explained by Dr. Avera, this concern was shared by many participants in
15 the western electricity markets at that time. Billings under the PSA were
16 high not only in the summer of 2000, but also well into the fall and winter,
17 and spiked in May 2001. Therefore, Citizens reasonably expected that
18 billings in 2001 might continue at the very high levels of the summer of
19 2000, dramatically increasing Citizens' and its ratepayers' exposure.
20 Combined with my firm's advice to Citizens that the litigation route did not
21 look promising, the case for settlement was strong, and Citizens' pursuit of
22 a negotiated resolution was very reasonable under the circumstances.

23

24 Q. Dr. Rosen similarly testifies (at page 1) that filing a FERC complaint would
25 have "pressured APS into more quickly negotiating a more comprehensive
26 fix for the contract language." Do you agree?

27

28

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1 A. No, for the same reasons as given above. The degree of pressure on a
2 respondent is directly related to the level of merit of the complaint. As I
3 stated in my rebuttal testimony, we were particularly concerned that
4 Citizens' issue would not present a strong FERC complaint. And I have no
5 reason to believe that APS could not have come to the same conclusion.
6

7 Q. Dr. Rosen testifies (at page 1) that Citizens should have filed a complaint
8 with FERC in May 1999, and no later than January 2001. Was Citizens
9 imprudent because it did not file a FERC complaint in that timeframe?

10 A. No. It is not clear what would have been gained from filing a complaint
11 that, unfortunately, we now know would likely have failed.
12

13 The appropriate question is whether Citizens' course of conduct during this
14 time period was reasonable. Citizens focused considerable effort on
15 negotiating with APS a resolution of the disputed points. This was a
16 reasonable course, given Citizens' track record of successful power supply
17 negotiations with APS. The PSA was understandably viewed by Citizens
18 (from the perspective of 1999 and early 2000) as a successful product of
19 negotiations with APS. It had resulted in a reduction in Citizens' purchased
20 power costs and provided significant benefits to Citizens' ratepayers for
21 nearly five years. Citizens also had just completed in 1999 arduous
22 negotiations with APS that, as a result of Citizens' persistence, ultimately
23 resulted in a significant reduction in the stipulated rates for service under
24 Schedule A to the PSA. In 2000, Citizens negotiated with APS for a partial
25 refund to resolve an initial billing dispute about the PSA's system
26 incremental cost ("SIC") provisions, and the parties agreed on what
27 Citizens thought was a conceptual framework that would avoid the SIC
28 problem of exposure to higher cost market purchases. As is often the case
29

1 in this type of negotiation, the parties committed that agreed framework to
2 writing, in the form of the May 18, 2000 Memorandum of Understanding
3 between Citizens and APS ("MOU"), which the parties recognized was
4 subject to the execution of a later definitive agreement. This is the same
5 course that APS and Citizens followed when they negotiated the PSA five
6 years earlier. They entered into a letter of intent in September of 1994,
7 and followed that with a definitive, binding agreement (i.e., the PSA) in
8 January of 1995. Letters of intent and memoranda of understanding
9 usually are non-binding; nonetheless, they serve a useful purpose in
10 memorializing the concepts on which the parties believe they have reached
11 agreement, structuring and focusing the parties' subsequent negotiations.
12 In this instance, however, apparently because of the intervening very high
13 market costs of power, APS pulled back in August 2000 from the
14 understanding that Citizens thought had been achieved in the MOU.
15 Citizens then began to consider the possibility of litigation. As discussed in
16 my rebuttal testimony, Citizens retained Wright & Talisman and we
17 engaged in an extensive analysis of this matter, ultimately concluding that
18 Citizens would do best to negotiate a resolution with APS.

19
20 Q. Ms. Smith similarly contends (at page 7) that Citizens should have taken
21 additional action in the late-1999 to summer-of-2000 time period and that
22 "outside counsel and advisors would have provided a more effective team,
23 that would have provided more leverage in negotiations." Is this a valid
24 criticism?

25 A. No. As explained by Mr. Breen, Citizens in 1998 retained the services of
26 Mr. Alan Heintz, a former senior FERC staffer, to assist Citizens in its
27 dispute with APS. Mr. Heintz is one of the most knowledgeable FERC
28 electric rate consultants with whom I have had the privilege to work, and
29

1 my firm has recommended him to many of our clients. When Citizens
2 retained Wright & Talisman, I was pleased to learn I would be working with
3 Alan. I understand that Citizens also had regular access to competent
4 outside FERC counsel during this entire time period and, of course, it also
5 has internal counsel to advise it as well.
6

7 Q. Ms. Smith asserts (at page 3) that Citizens still should file a complaint at
8 FERC "instead [of] asking ratepayers to cover this potential overbilling."
9 Dr. Rosen similarly testifies (at page 5) that Citizens "should still proceed to
10 file a complaint at FERC in order to get final official clarification of the
11 contract interpretation dispute between Citizens and APS." Both witnesses
12 take the position that Citizens should be denied recovery of \$70 million of
13 power costs that Citizens incurred to serve its customers until after Citizens
14 has pursued a FERC complaint. Is their proposed procedure reasonable?

15 A. No. The criteria for recovery of Citizens' costs in this case is not whether
16 FERC provides "a final official clarification," but whether Citizens acted
17 reasonably based on the circumstances. Ms. Smith and Dr. Rosen advocate
18 a FERC filing simply for the sake of a filing, with no demonstration that a
19 FERC complaint would be effective. More to the point, they provide no
20 basis to conclude that the failure to file a FERC complaint rises to
21 imprudence. Nor can they. As I discussed at length in my rebuttal
22 testimony, we considered this issue very carefully. Unfortunately, all three
23 former senior FERC staffers that we consulted in our search for an expert
24 witness for Citizens opined that FERC likely would find in favor of APS'
25 contract interpretation on the SIC issue--just the opposite of the opinion we
26 were seeking. Under the circumstances, Citizens' decision not to file a
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1 FERC complaint was quite reasonable. Precluding Citizens now from
2 recovering its costs pending pursuit of a FERC complaint that is not likely to
3 provide relief would not be based on any standard of reasonableness--it
4 would simply be punitive.

5
6 Q. Dr. Rosen seems optimistic (at page 5) that FERC will find in Citizens' favor
7 in such a proceeding, in part based on the MOU. Is his position persuasive?

8 A. No. He never explains why he thinks the MOU would produce a positive
9 outcome for Citizens at FERC. On its face, the MOU is titled "Terms of a
10 Potential Restructuring of the Existing Power Supply Agreement" (emphasis
11 added). Moreover, the MOU is barely more than one page long and is in the
12 form of an outline of terms. Immediately after the MOU was executed,
13 Citizens and APS entered into negotiations to elaborate its pricing terms. All
14 of this strongly indicates that the MOU was not a definitive agreement, but
15 rather was a framework for a later definitive agreement to be negotiated
16 and executed. Therefore, although Citizens reasonably relied on the MOU
17 in the summer of 2000 as a tangible sign that its negotiating strategy was
18 leading toward a resolution of the SIC issue, the MOU would not provide a
19 very good grounds for a FERC complaint or lawsuit because it was not a
20 definitive power purchase agreement.

21
22 Q. Dr. Rosen argues (at page 3) that this Commission should order Citizens to
23 file a complaint at FERC and that in this state-mandated FERC proceeding,
24 the parties would seek refunds from APS for power purchase prices passed
25 through to Citizens that "were not just and reasonable for much of the time
26 from May 2000 through May 2001." Is this recommendation reasonable?

1 A. No. FERC already has a proceeding to address possible refunds to
2 purchasers in western markets after October 2000. APS was a direct
3 purchaser in such markets and is participating in the FERC refund
4 proceedings. To the extent FERC orders refunds in those proceedings, APS
5 will have to recalculate its system incremental cost and adjust its past
6 billings to Citizens.

7
8 Q. Does that conclude your rejoinder testimony?

9 A. Yes.

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1
2 **REJOINDER TESTIMONY**
3 **OF**
4 **CARL W. DABELSTEIN**
5 **CITIZENS COMMUNICATIONS COMPANY**
6 **ARIZONA ELECTRIC DIVISION**

7
8
9 **DOCKET NO. E-01032C-00-0751**

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26 **MARCH 19, 2002**
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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 and
7 rebuttal testimonies in this proceeding?

8 A. Yes, I am

9
10 Q. What is the purpose of your rejoinder testimony?

11 A. I am submitting rejoinder testimony to portions of the surrebuttal
12 testimony filed by Commission Staff witness Lee Smith.

13
14 Q. To what portions of Ms. Smith's surrebuttal testimony is your rejoinder
15 testimony responding?

16 A. I am presenting rejoinder testimony with respect to the following areas of
17 her surrebuttal testimony:

- 18 • The use of financial hedges.
- 19 • Expectations of high market prices.
- 20 • The use of the Valencia facilities to serve load.
- 21 • Updating the PPFAC Bank.
- 22 • Commission Rule R14-2-1606.B.
- 23 • Carrying costs on the PPFAC Bank balance.

1 **USE OF FINANCIAL HEDGES**

2 Q. With what portions of Ms. Smith's surrebuttal testimony on hedging do you
3 disagree with?

4 A. On page 9 of her surrebuttal, Ms. Smith renews her criticism about Citizens
5 not using hedging techniques or instruments in response to my rebuttal
6 testimony. In my rebuttal, I explained Citizens' reluctance to embark on a
7 potentially very risky, very costly, and previously uncharted course without
8 guidance from the Commission on under what circumstances to engage in
9 such a practice, how such costs are to be recovered and what standard of
10 prudence would be imposed on the Company. She erroneously
11 characterized such action as considering Company stockholder interests
12 only.

13
14 Q. Do you agree with that assessment?

15 A. No I do not. It is very reasonable for a utility to attempt to obtain
16 regulatory clarification of appropriate action, cost recoverability, and/or the
17 prudence standards to be imposed before undertaking an unprecedented
18 financial obligation that could have significant impacts on both the utility's
19 investors and customers. For example, I am aware of a gas distribution
20 utility in a nearby state that agreed to adopt hedging techniques for about
21 30% of its winter supply requirements, only after it received regulatory
22 assurance that the related costs could be recovered through its PGA
23 account, and where it was recognized that hedging would not necessarily
24 result in least-cost supply, and that it would not be subject to disallowances
25 or penalties based on 20-20 hindsight.

1 Citizens is interested in being afforded a reasonable opportunity to recover
2 its costs of service. It is equally interested in providing safe, reliable
3 service at the lowest possible price without creating significant rate shock,
4 as evidenced by the Company extending the traditional one-year recovery
5 period under the PPFAC mechanism to three-years in its September 2000
6 application and then to seven years in the amended application filed in
7 September 2001. Not proceeding with hedging activities in early 2000,
8 when there was no expectation of price spikes, no guidance on when the
9 Commission considered hedging appropriate, and no regulatory direction
10 with respect to the treatment of costs incurred, was a reasonable decision
11 at the time in the best interests of both the Company and its ratepayers,
12 based on all available information at the time.
13

14 Q. Is there a risk of not seeking guidance from the Commission?

15 A. Yes, there are several. First, there is the uncertainty associated with how
16 the Commission would judge prudence with respect to the concept of
17 hedging. As stated, prudence is judged by what was a reasonable decision
18 at the time it was made, based on all readily available information. In this
19 case, the Commission hasn't even addressed the threshold question of
20 whether hedging is appropriate at all. From the testimony filed by Staff
21 and RUCO witnesses in this proceeding, it is clear that they believe the door
22 to Monday morning quarterbacking should be left open, creating
23 tremendous uncertainty for the utility and its customers. As evidenced by
24 the way the concept has been addressed in connection with the Purchased
25 Gas Adjustor and in workshops conducted to explore natural gas
26 procurement issues, it appears that the Commission and the Staff are of
27 the same or a similar opinion at this time.
28
29

1 Another risk is that of the potential for inconsistent regulatory treatment
2 due to a misunderstanding of the concept of hedging. Financial hedging is
3 the non-speculative use of financial derivatives to remove volatility from
4 customer bills, not necessarily to lower bills, but to improve the
5 predictability of bills. The Commission has recognized rate stability as a
6 desirable goal, one with which the objectives of hedging are consistent.
7 Nevertheless, it must also recognize that costs can go up or down under
8 hedging. A utility expected to adopt hedging tools should be subject to
9 symmetrical regulatory and cost recovery treatment.

10
11 Finally, there is an accounting (and ultimately a cost-recovery) risk
12 associated with the adoption of hedging before obtaining regulatory
13 guidance. As I previously testified, until very recently, the FERC had issued
14 no specific accounting direction for reflecting hedging transactions in its
15 Uniform System of Accounts. It was not totally clear how such amounts
16 should be accounted for. Hedging costs would be a key component of
17 supply costs, and as such, should be allowed to be recorded in the PPFAC
18 Bank. Unfortunately, there exists no current authorization for Citizens to
19 record such amounts in the PPFAC Bank. Absent such specific authority,
20 hedging expenditures could alternatively be accumulated in a balance sheet
21 deferral or regulatory asset account. That too, requires advance approval
22 by the Commission. Without the authority to preserve hedging costs for
23 future regulatory recovery in either the PPFAC Bank or a deferral account,
24 they will have to be charged to an operating expense account, which unless
25 that occurs during a month that will ultimately be included in a test year to
26 be used for ratemaking, means they will not be recoverable.

1 Q. Has Citizens experienced any economic consequences as a result of not
2 approaching the Commission in connection with new programs and the
3 recovery of the related costs?

4 A. Yes. I am aware of two such instances that occurred prior to my arrival at
5 the Company, both of which were addressed in connection with the last
6 general rate case for the Arizona Electric Division.

7
8 Q. Please explain.

9 A. According to Decision No. 59951, issued January 3, 1997, the Company
10 sought recovery of \$424,967 spent in connection with Integrated Resource
11 Planning activities and DSM programs. The Commission accepted the
12 positions by Staff and RUCO that such amounts such be disallowed because
13 they had not been pre-approved.

14
15 Decision No. 59951 also included a disallowance of \$390,956 costs incurred
16 in connection with the development and start-up of TARGET: Excellence, a
17 program intended to improve customer service and employee productivity.
18 The Commission did allow the Company to recover one-half of the current
19 period costs, or \$85,013. Among the reasons cited for the disallowance of
20 the development and start-up costs was the fact that the Company had
21 apparently never sought Commission approval to accumulate such costs in
22 a deferral account.

23
24 Based on the foregoing examples, it is clear that there is a definite risk of
25 non-recovery by implementing something new without first seeking
26 guidance from the Commission.

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1 Q. What prudence standard do you believe should be employed by the
2 Commission in the event that Citizens decided to use hedging techniques to
3 manage supply price risk?

4 A. I believe that a standard relating to investments that the Commission could
5 refine and apply for purposes of evaluating utilities' hedging activities is
6 already in place. R14-2-103.A includes the following definition for
7 "prudently invested":

8
9 *Investments which under ordinary circumstances*
10 *would be deemed reasonable and not dishonest*
11 *or obviously wasteful. All investments shall be*
12 *presumed to have been prudently made, and*
13 *such presumptions may be set aside only by clear*
14 *and convincing evidence that such investments*
15 *were imprudent, when viewed in the light of*
all relevant conditions known or which in the
exercise of reasonable judgment should have
been known, at the time such investments were
made.

16 With slight modifications, that definition could be used to provide the
17 necessary guidance for undertaking hedging activities. Absent such
18 guidance which the Commission has not given since 1998 in the context of
19 natural gas distribution, and in this case since the initial application was
20 filed in September 2000, hedging is simply too speculative for this
21 company.

22
23 **HIGH POWER MARKET PRICES**

24 Q. With what portion of Ms. Smith's surrebuttal dealing with high power
25 market prices do you disagree with?

26 A. On pages 11 and 12, she disputes the rebuttal testimonies of Mr. Avera and
27 myself, relating to expectations of high prices on the power markets during
28 the summer of 2000. She criticizes the fact that we cited her testimony in
29

1 connection with the AEPCO case and Citizens settlement agreement while
2 not discussing the TEP and APS settlements. She states that she did not
3 make any projections of future market prices, but continues to fault
4 Citizens for not doing so.

5
6 It is my understanding that Ms. Smith assisted the Commission Staff in
7 analyzing all four stranded cost cases: APS, TEP, AEPCO, and Citizens.
8 With LaCapra Associates retained to advise the Staff at that very critical
9 time in the Arizona Electric Restructuring process, it is most difficult to
10 understand why Ms Smith would have expressed no opinions to her client,
11 the Commission Staff, about her expectations of the future market prices.
12 Such input would have been vital to achieving a proper understanding by
13 the Staff person ultimately responsible for making the decision to commit to
14 the settlement agreement or case position.

15
16 By definition, stranded costs imply a situation where the market clearing
17 price for power available to customers of a utility is less than that
18 company's avoided generation cost. If that relationship does not exist,
19 there are no stranded costs. Each of the stranded cost cases provide for
20 some type of computing, tracking, and recovering stranded costs. In all
21 cases, there was extensive concern and debate about stranded costs. If
22 there were a clear expectation of higher, not lower, market prices for
23 power, that concern would definitely have impacted each case. There is no
24 evidence that Ms. Smith or her firm sounded any such warning in late 1999
25 or early 2000 about the appearance in price spikes in the near term.
26 Moreover, as I identified in my rebuttal testimony, her testimony given
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1 during February and June 2000 strongly pointed to lower market prices, not
2 higher. The consideration of stranded cost clauses in each of the four cases
3 clearly implies that there was more than just a remote expectation that
4 market prices would be less, not more, than utilities' avoided costs.
5

6 **USE OF VALENCIA FACILITIES**

7 Q. Concerning the use of the Valencia generating facilities, with what portion
8 of Ms. Smith's surrebuttal do you disagree?

9 A. At page 13, Ms. Smith continues to criticize the Company for not
10 dispatching the Valencia generating units in Nogales to serve customer load
11 at times of APS incurring high market prices during the summer of 2000.
12

13 Q. Is that criticism valid?

14 A. No. As already explained in testimony and in discovery, the Valencia units
15 were never designed to carry customer load for economy reasons. As
16 established in previous rate cases, as well as Citizens' unbundled tariff
17 filing, because they were installed for the sole purpose of being emergency
18 back-up units to serve customers in Santa Cruz County only in the event
19 the transmission line into that area went down, they were actually viewed
20 as part of the distribution system. For a variety of operational and
21 environmental reasons, that units could not have been dispatched to serve
22 load for economy purposes during the summer of 2000 without significant
23 modifications, and without seriously jeopardizing reliability.
24

25 It should be noted that for short periods during May and June of 2001, the
26 units were run for economic purposes. This occurred as a result of
27 discussions at informal meetings with Staff consultants (Vantage
28 Consulting, not LaCapra Associates) in the fall of 2000 where Citizens'
29

1 original PPFAC surcharge application was discussed. The consultants
2 strongly recommended that Valencia be dispatched for economy reasons.
3 Citizens assumed that Staff's consultants were representing Staff's position.
4 As a result of the discussions, Citizens carefully considered the issue and
5 then implemented a number of improvements and upgrades to the units
6 over a 4 to 5 month period so that they could carry full load. For a brief
7 time, Citizens did dispatch Valencia for economic reasons, resulting in cost
8 savings to its customers; however, that effort was short-lived.

9
10 On June 20, 2001, a transmission line outage occurred causing a service
11 disruption that was brought to the attention of the Commission Engineering
12 Staff. On July 26th a letter was sent to the Company by Acting Utilities
13 Division Director Steve Olea, a copy of which I have attached as CWD-5.
14 As indicated, the Staff was concerned that the decision to operate Valencia
15 for other than emergency purposes created reliability issues and was
16 contrary to an agreement reached with Staff and addressed in Commission
17 Decision Nos. 61383, 61793, and 62011. It was at this point in time that
18 Citizens became aware that the Staff did not support the continued use of
19 Valencia facility other than for its original intended purpose, as emergency
20 back-up generation only.

21
22 Q. Could Citizens have dispatched the Valencia units for economy purposes
23 during the summer of 2000 as it did in 2001, as suggested by Ms. Smith?

24 A. I do not believe so. As previously stated, there were a number of
25 operational and environmental reasons that prevented the Company from
26 using them in that manner during the summer of 2000. The improvement
27 and upgrade work performed on Valencia during late 2000 and early 2001
28 would have had to have been completed before such operation could have
29

1 occurred during the summer of 2000 without seriously affecting operating
2 performance of the units or reliability. Such work would have had to have
3 begun in late 1999 or early 2000, a time when there was no expectation of
4 the price spikes that later occurred. Moreover, if such work began as soon
5 as the Company received its May 2000 power bills in late June, the summer
6 would have been over before the necessary work was completed. Finally,
7 in either summer, it was a difficult decision to run the units for economic
8 reasons. Because total operating time is limited and a prolonged or severe
9 storm season is not predictable, the units may not be available for
10 reliability, if the operating limit has been reached.

11
12 **UPDATING THE PPFAC BANK**

13 Q. What does Ms. Smith propose in connection with the PPFAC Bank?

14 A. Beginning at page 16 of her surrebuttal testimony, Ms. Smith opines that
15 the PPFAC Bank data be updated. She provides an estimated balance of
16 \$105 million by the end of April 2002.

17
18 Q. Do you have information more current than that previously provided?

19 A. Yes. CWD-6 is an analysis of the PPFAC Bank for the month of December
20 2001, included as Schedule FA-1 in the required monthly filing submitted to
21 the Commission on March 4, 2002. It reports an actual under-recovered
22 balance of \$99,885,471 as of December 31, 2002. The most recent
23 updating of the Company's application projected a year-end 2001 balance
24 of \$99.6 million.

25
26 With respect to projected month-end Bank balances, CWD-7 is a copy of
27 the Schedule FA-4 also included in the monthly PPFAC report filed with the
28 Commission on March 4, 2002. It projects the monthly Bank activity and
29

1 ending balances for the next six months. As indicated thereon, the
2 balances projected for April and June 2002 are \$105.6 million and \$109.7
3 million, respectively. Such amounts reflect no PPFAC surcharge recoveries.
4

5 Q. In her surrebuttal, Ms Smith comments that the Commission could issue an
6 order that reflects PPFAC Bank balances or surcharge implementation dates
7 different from what has been filed by the Company in its initial application
8 and subsequent amendments and revisions. Does that affect or change the
9 PPFAC surcharge rate requested by the Company?

10 A. Assuming that the Company is allowed to fully recover the requested PPFAC
11 costs, it does not. The requested PPFAC Surcharge is comprised of two
12 parts. The first part is intended to recover the existing PPFAC Bank balance
13 plus carrying costs over the term of the new APS power supply agreement.
14 The second part is intended to raise the existing power supply cost
15 recovery rate to a level reflecting current WAPA and APS costs. By
16 increasing the current cost recovery rate to equal the current cost rate, the
17 existing under recovery in the PPFAC Bank will not increase during the
18 period the surcharge is in place. That part of the requested surcharge is
19 not affected with the passage of time while this application is being
20 considered.

21
22 The other portion of the requested surcharge currently before the
23 Commission is intended to recover the most current, known PPFAC Bank
24 balance plus projected increases through the month during which a
25 surcharge may be implemented. The most recent updating of the PPFAC
26 data reflected the actual bank balance as of November 30, 2001, plus
27 forecasted increases through June 2002, the month during which it was
28 anticipated that the requested surcharge rate would be implemented. As
29

1 long as the Company is permitted to recover all of its deferred PPFAC costs,
2 changes in the PPFAC Bank occurring since the last updating of data plus a
3 one-month difference between the expected implementation date and the
4 actual date when the rate may be charged has no effect on the Company's
5 request. Simply stated, Citizens is requesting a \$.028149/kWh surcharge
6 over the period of the new APS power supply agreement.
7

8 **COMMISSION RULE R14-2-1606.B**

9 Q. What is R14-2-1606.B?

10 A. R14-2-1606.B requires all investor-owned utility distribution companies
11 regulated by the Commission to acquire at least 50% of power required for
12 Standard Offer customers through a competitive bid process.
13

14 Q. What is Ms. Smith's recommendation with respect to R14-2-1606.B?

15 A. At page 18 of her surrebuttal, she states that the new power supply
16 agreement with APS appears to be inconsistent with that requirement, and
17 thus, the Commission should consider whether the Company is in
18 compliance.
19

20 Q. Do you agree with that assessment?

21 A. No I do not. On January 18, 2001, the Commission hearing officer in the
22 Company's stranded cost and unbundled tariff dockets issued a procedural
23 order granting a requested waiver from the requirements of R14-2-1606.B.
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1 **ACCRUING CARRYING COSTS IN THE PPFAC BANK**

2 Q. What position on the accrual of carrying costs on the PPFAC Bank balance is
3 contained in Ms. Smith's surrebuttal testimony?

4 A. Ms. Smith continues to advocate no accrual of carrying charges. In addition
5 to her previous testimony that such recommended denial should be viewed
6 as a penalty, she states on page 19 of her surrebuttal that it is normal
7 ratemaking policy to reduce utilities' rates of return when regulators find
8 management performance deficient.

9
10 Q. Do you agree with that position?

11 A. I certainly do not. Not only does Ms. Smith fail to consider the fundamental
12 economic justification for the accrual of carrying charges (which the
13 Commission has properly recognized in connection with the PGA
14 mechanism), but also ignores the fact that, while the Commission has
15 historically permitted under-recovered PPFAC Bank balances to be
16 recovered in twelve months or less, Citizens voluntarily proposed extending
17 the recovery period to seven years in order to mitigate rate shock for its
18 customers.

19
20 I am aware that, in some circumstances, regulators have adjusted
21 downward the allowed return on equity of utilities found to have been guilty
22 of imprudence or malfeasance. Such reductions were made only to the
23 common equity component of the rate of return; neither the debt nor
24 preferred equity components were affected. Citizens has not acted
25 imprudently or with malfeasance, so that approach is inappropriate here.
26 The authority to begin accruing carrying charges on the PPFAC Bank being
27 sought by Citizens reflects no common equity return or component. The
28
29

1 requested carrying charge accrual procedure would be based on a rate
2 equal to that used to accrue interest on customer deposits held by the
3 Company.

4
5 The PPFAC and PGA mechanisms in Arizona were implemented to enable
6 the Commission and affected utilities to review energy supply costs and to
7 adjust recovery rates without having to incur the costs and expend the time
8 and effort typically associated with a general rate case. This PPFAC
9 surcharge application has already consumed a greater amount of time and
10 expenses than any rate case request it ever filed by Citizens in Arizona.
11 Generally, utilities are permitted to recover the costs of preparing and
12 defending a rate case over the time that the new rates are expected to be
13 in effect. In addition to an estimated \$10 million in unrecoverable financing
14 costs associated with the investment in the PPFAC Bank during the past
15 twenty months to which I have previously testified Citizens has also
16 incurred hundreds of thousands of dollars in legal and consulting fees in
17 connection with this applications that too, are unrecoverable. To further
18 "penalize" the Company by not allowing the accrual of carrying costs on an
19 amount that will require seven years for recovery is totally unfair and
20 unwarranted.

21
22 **CONCLUSION**

23 Q. What is your overall recommendation to the Commission with respect to
24 Ms. Smith's testimony?

25 A. Most of the issues raised in this proceeding are very technical and
26 complicated. Many of Ms. Smith's comments and recommendations are
27 based on 20-20 hindsight, or information that was uncertain, conflicting,
28

1 impractical, or not readily available at the time decisions had to be made by
2 the Company in order to provide its customers with safe, reliable electric
3 service.

4
5 While the Commission has been provided with literally hundreds of pages of
6 very complicated and, in many instances, very conflicting testimony from
7 Ms. Smith and the other witnesses, the fundamental determination that it
8 must make is clear — were the actions and decisions of Citizens reasonable
9 under the circumstances, based on all relevant information available to it at
10 the time? The answer is yes, to that question. The Company should be
11 permitted to implement the requested PPFAC surcharge and to begin
12 accruing carrying charges on the Bank balance.

13
14 Q. Does this conclude your rejoinder testimony?

15 A. Yes it does.

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WILLIAM A. MUNDELL
CHAIRMAN

JIM IRVIN
COMMISSIONER

MARC SPITZER
COMMISSIONER



BRIAN C. McNEIL
EXECUTIVE SECRETARY

ARIZONA CORPORATION COMMISSION
July 26, 2001

Mr. Sean Breen
Citizens Utilities Company
1300 South Yale Street
Flagstaff, Arizona 86001

RE: CITIZENS SANTA CRUZ COUNTY ELECTRIC DIVISION

Dear Mr. Breen:

Attached is a memorandum from the Utilities Division Engineering Staff (Engineering) that discusses several power outages that occurred in Santa Cruz County last month. Although, there seems to have been some confusion caused by discussions with a Utilities Division Staff (Staff) consultant, Staff is concerned that Citizens made the decision to operate the Valencia generators, in Nogales, Arizona, to serve load in other than an emergency power situation without first contacting and/or notifying the Arizona Corporation Commission (Commission) or Staff.

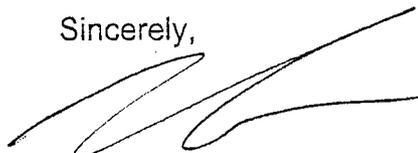
Based on the attached memorandum, I would recommend that the Valencia generators be operated only as emergency backup as contemplated in the Plan of Action as per Commission Decisions Nos. 61383, 61793, and 62011. If Citizens desires or believes it is necessary to operate these generators in any other capacity, please submit a plan for Commission approval as outlined in the Engineering memorandum.

In addition, I would request that Citizens report all outages of the one 115,000 volt transmission line that serves Santa Cruz County, regardless of the outage duration and the number of customers effected. Citizens should also report all outages that occur in its Santa Cruz electric distribution system, except for those that are momentary.

Sean Breen
July 26, 2001
Page 2

Thank you in advance for your prompt attention to the above matters. If you have any questions, please feel free to contact Asher Emerson, Jerry Smith, or me at 602-542-4251.

Sincerely,



Steve Olea
Acting Director, Utilities Division

SMO:mi
Attachment

cc: Chris Kempley w/attachment
Del Smith w/attachment
Jerry Smith w/attachment
Asher Emerson w/attachment
Ernesto Ojeda, Citizens, Santa Cruz County w/attachment

Memorandum

To: Steve Olea
CC: Del Smith, Jerry Smith
From: Asher Emerson *Asher Emerson*
Date: 07/25/01
Re: Outage on Citizens Transmission Line

On June 25, 2001, the Commission received a complaint that the Tubac, Arizona area had power outages on Wednesday (June 20th), Thursday (June 21st) and Saturday (June 23rd). Engineering Staff (Engineering) investigated the complaint and discovered Citizens had not followed its agreed upon operating procedures that could have prevented the June 20th outage. In addition, only the June 20th outage was reported to Staff.

The Commissioners, in Decision No. 62011, adopted Citizens' settlement agreement with Staff. The settlement agreement concerning Citizens' Plan of Action to address service quality issues in the Santa Cruz Electric Division was docketed in Docket No E-01032A-99-0401. Citizens' Plan of Action as filed on April 15th, 1999, and supplemented on May 7th, 1999 and July 13th, 1999, complies with Decisions Nos. 61383 and 61793. The Plan of Action included operating procedures committing that during storm season all three Valencia gas turbines would be started any time a storm rolled in and would be operated at 100 percent speed **with no load**. Plant personnel would also man the plant from 3:00 P.M. to midnight on such occasions.

Engineering believes that the primary reason for the outage on June 20th was that Citizens was operating the generators **to serve load** with the reclosing relays blocked or take out of service. Because of this, the generators were unable to respond to the loss of Citizens' transmission line, thereby, resulting in a preventable outage.

July 25, 2001

During discussion with Citizens personnel on why they were operating the generators to serve load, they stated that a Utilities Division Staff consultant told them to use the backup generation to save money when the price of electricity was high. Although the subject was discussed in a meeting between Staff, the Consultant and Citizens concerning Citizens Purchased Power and Fuel Allowance (PP&FA), Staff believes that Citizens misinterpreted the discussion. However, regardless of whether or not there was a misinterpretation, Staff believes that Citizen had the responsibility to not only inform Staff of its decision to run the Valencia generators to serve load, but to also seek Commission approval to do so since the operation of the Valencia generators is part of the Plan of Action specifically tied to Commission decisions.

It is Engineering's opinion that Citizens did not comply with its own Plan of Action that was part of Decisions Nos. 62011, 61383 and 61793 by running the Valencia generators to serve load, thus not having them available to respond to loss of Citizens' transmission line.

Engineering recommends that Citizens comply with its Plan of Action as per Decisions Nos. 62011, 61383 and 61793 and operate the Valencia generators as backup for emergencies. However, if Citizens wishes to operate its Valencia generators to serve load other than during emergencies, Citizens should submit a plan for Commission approval to do so. The plan should, at a minimum, include the following:

1. Detailed explanation of exactly when and why the generators will be operated.
2. Detailed operating procedures explaining exactly how the generators will be operated and still provide emergency backup to the Santa Cruz County customers.
3. Detailed procedure for notifying Utilities Division Staff before beginning operation of the generators for other than emergency backup.
4. Proposed fuel usage plan including quantities of gas or diesel.

July 25, 2001

5. Any related hours of restriction imposed on use of generators as emergency backup during storm season to remain in compliance with your air emissions permit.

In addition, Engineering would recommend that Citizens be required to report all outages of its transmission line serving Santa Cruz County, regardless of the duration of the outage or the number of customers affected. Citizens should also be required to report all outages of its distribution system in Santa Cruz County, except for those that are momentary and are corrected by operation of Citizens' reclosers.

**CITIZENS COMMUNICATIONS COMPANY
ARIZONA ELECTRIC DIVISION
PURCHASED POWER AND FUEL ADJUSTOR
BANK BALANCE REPORT FA-1
For the Month of December 2001**

Line No.

1	Ending Balance - Prior Month	Under Collected	\$ 97,744,466
2	Jurisdictional Sales	95,011,535	
3	Actual Cost of Generated and Purchased Power	7,075,904	
4	Unit Cost of Power (\$/kWh) (line 3 / line 2)		0.074474
5	Authorized Base Cost of Power (\$/kWh)	0.051940	
6	Authorized Purchased Power Adjustor (\$/kWh)	-	
7	Net Power Costs Billed Customers (\$/kWh) (line 5 + line 6)	<u> </u>	<u>0.051940</u>
8	(Over) / Under-recovery of Power Supply Costs (\$/kWh) (line 4 - line 7)		<u><u>0.022534</u></u>
9	Net Increase / (Decrease) in Bank Balance (line 2 X line 8)		2,140,990
10	Adjustments to Bank Balance: Computational Roundings		<u>15</u>
11	Ending Bank Balance - Current Month (line 1 + line 9 + line 10)		<u><u>\$ 99,885,471</u></u>
			Under-collected

**CITIZENS COMMUNICATIONS COMPANY
ARIZONA ELECTRIC DIVISION
Fuel Adjustment Six-Month Forecast
Reporting Month - December 2001**

Line No.	Description	Units	January 2002	February 2002	March 2002	April 2002	May 2002	June 2002
1	Generated and Purchased Power	kWh	111,508,618	105,300,740	101,162,709	98,071,337	103,388,680	122,047,099
2	Sales	kWh	107,337,378	101,675,964	95,701,242	92,329,186	91,497,125	102,296,090
3	Generation Costs:							
4	Gas-fired	\$						
5	Oil-fired	\$	5,653	5,653	5,653	5,653	5,653	5,653
6	Coal-fired	\$						
7	Purchased Power Costs:							
8	Base Meter Charge	\$						
9	Demand Charge	\$	457,555	457,555	457,555	457,555	457,555	457,555
10	Energy Charge	\$	6,555,592	6,190,630	5,947,356	5,765,614	6,078,221	7,175,149
11	Total Cost of Generation and Purchased Power	\$	7,018,799	6,653,838	6,410,563	6,228,821	6,541,428	7,638,357
12	Less: Costs to Serve Exempt Customers	\$						
13	Net Cost of Generation and Purchased Power	\$	7,018,799	6,653,838	6,410,563	6,228,821	6,541,428	7,638,357
14	Net Unit Cost (line 13 / line 2)	\$/kWh	0.065390076	0.065441603	0.066985162	0.067463191	0.071493264	0.074669095
15	Power Cost in Base Rates	\$/kWh	0.051940	0.051940	0.051940	0.051940	0.051940	0.051940
16	PPFAC Adjustment Factor	\$/kWh						
17	Net Power Costs Billed	\$/kWh	0.051940	0.051940	0.051940	0.051940	0.051940	0.051940
18	Net Unit Cost (Over) / Under Recovery (line 14 - line 17)	\$/kWh	0.013450	0.013502	0.015045	0.015523	0.019553	0.022729
19	Net (Over)/Under Power Supply Cost Recovery (ln 2 X ln 18)	\$	1,443,696	1,372,788	1,439,841	1,433,244	1,789,067	2,325,098
20	Beginning PPFAC Bank Balance	\$	99,885,471	101,329,166	102,701,955	104,141,796	105,575,039	107,364,107
21	Ending PPFAC Bank Balance	\$	101,329,166	102,701,955	104,141,796	105,575,039	107,364,107	109,689,204

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**REJOINDER TESTIMONY
OF
PATRICIA M. ECKERT

CONSULTANT FOR
CITIZENS COMMUNICATIONS COMPANY
ARIZONA ELECTRIC DIVISION**

DOCKET NO. E-01032C-00-0751

MARCH 19, 2002

1 **INTRODUCTION AND QUALIFICATIONS**

2 Q. Please state your name and business address.

3 A. My name is Patricia M. Eckert. My business address is 56 Casa Way, San
4 Francisco, California.

5
6 Q. By whom are you employed and in what capacity?

7 A. I am self-employed as an industry consultant. I provide regulatory,
8 advisory and business development services to a number of clients in the
9 telecommunications and the utility industries.

10
11 Q. Please describe your educational background, professional qualifications,
12 and prior experience.

13 A. I graduated cum laude with a degree in business from Parsons College, and
14 hold a Juris Doctor Degree from Loyola Law School in Los Angeles. I
15 served as the President of the California Public Utilities Commission
16 ("CPUC") in 1991, and as a Commissioner from 1989 through 1994. As
17 President, I initiated a comprehensive review of California's electric utility
18 industry and was one of the initial architects of California's electric industry
19 restructuring. Prior to my service with the CPUC, I was a partner in the law
20 firm of Eckert and Colman, which specialized in business transactions, real
21 estate and taxation. Before entering private law practice, I worked for
22 more than 14 years as a business and marketing executive. In recent
23 years, I have advised Fortune 100 clients on a variety of regulatory and
24 partnering issues, and have facilitated strategic alliances in the California
25 markets. I am currently a member of the Board of Directors of Dynergy
26 and serve on the advisory board of Enertech Capital Partners. I have
27 attached a copy of my curriculum vita as Exhibit PME-1.

1 Q. What is the purpose of your rejoinder testimony in this case?

2 A. My purpose is to respond to Staff and RUCO's continued assertions in their
3 surrebuttal testimony that Citizens acted imprudently. In responding to the
4 parties, I will:

- 5
- 6 • Briefly review the history of the CPUC's plan to deregulate or
7 restructure the electric power industry in California and how and why
8 that plan failed;
- 9 • Explain how the problems caused by the flawed California
10 deregulation plan led to unprecedented increases in the cost of power
11 in much of the Western United States, including Arizona;
- 12 • Explain why it is unreasonable to believe that a company like Citizens
13 could have foreseen what would happen to energy prices in the West
14 during the spring and early summer of 2000;
- 15 • Explain that Citizens was powerless to stop or otherwise influence the
16 increases in the cost of power that it experienced during that period;
- 17 • Share my perspectives as a former regulator as to what would be a
18 fair and reasonable means of dealing with the significant power costs
19 that Citizens incurred in providing service to its customers; and
- 20 • Describe those significant adverse consequences that I believe would
21 result if this Commission denies Citizens' request to be allowed to
22 recover from its customers the costs that it incurred in providing
23 power used by those customers.

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In addressing these issues, I will also respond to Staff and RUCO witnesses'
specific assertions that Citizens should have filed with the FERC and
allegations that Citizens acted imprudently.

1 Q. What is the basis of your knowledge and conclusions concerning the issues
2 that you are addressing in this hearing?

3 A. I have reviewed the testimony that has been filed in this case and
4 discussed the issues with Citizens' representatives. My experience as
5 President of the California CPUC and service as a Commissioner have
6 provided an understanding of the challenges facing the regulators, industry,
7 and consumers during the transition to electric deregulation. In my role as
8 a consultant, I have observed what took place in the power industry in
9 California over the past several years and I keep current on decisions
10 related to electric restructuring and direct access and understand the
11 complexities that surrounded significant changes in the fundamental
12 framework of the industry. My experience and knowledge has allowed me
13 to acquire a working knowledge of the Citizens Arizona Electric Division and
14 understand the effect the unprecedented power cost increases had on the
15 company. It is on that basis that my conclusions have been formed.
16

17 **SUMMARY AND CONCLUSIONS**

18 Q. Please summarize your conclusions.

19 The conclusions of my rejoinder testimony are as follows:

- 20
- 21 • California's plan for deregulation was fundamentally flawed, and as a
22 result, deregulation in California failed. This, in turn, had a
23 devastating effect not only in California, but the entire Western
24 United States.
 - 25 • The failure of California's deregulation plan created havoc for the rest
26 of the Western United States. As a result of California's failure,
27 supply became scarce and the cost of power skyrocketed in the
28 western states, including Arizona.
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- It is unreasonable to assume that Citizens could have foreseen what happened to energy prices in the spring and summer of 2000. No one – the government, the industry, consumers, or consultants - had anticipated the unprecedented rise in power costs that stunned the industry and consumers during the summer of 2000. The convergence of numerous factors, all which came together at the same time, caused the dramatic change to the marketplace. While Citizens would have been aware of some of the factors, there was no way to predict that they all would converge and cause the chaos that followed.
 - These unprecedented spikes in market prices had a devastating effect on Citizens and its customers. As market prices peaked, Citizens and its customers had no protection from the impact of the market. Citizens was not the cause of the dramatic spike in power costs, and was in no position to stop or otherwise influence the increases in the cost of power. Instead, Citizens and its customers found themselves in a vice, helplessly being squeezed by power suppliers and the effects of the failed California markets.
 - In determining whether Citizens actions were “prudent”, the fair and reasonable approach is to analyze the actions in the context of the time that the actions were taken. Judging negatively the prudence of actions in hindsight, particularly when there are volatile and completely unprecedented factors such as these market price increases, is patently unfair. At the time Citizens made decisions related to the purchase of power, those decisions were reasonable and prudent.
 - The issue to be determined in this matter is difficult, but straightforward. The record shows that as of July 2001, Citizens paid \$87.7 million to provide power to its customers. Those customers have already used the power, and all that is left to decide is the fairest and least painful way to repay Citizens for incurring the costs that were necessary to keep the lights on and the air conditioners running for its customers.
 - Citizens’ proposal to amortize the \$87.7 million (or actual updated balance) over seven years is reasonable and will help insulate the ratepayers from rate shock. Citizens has incurred carrying charges on this money without compensation since the

1 summer of 2000. On a going forward basis, it is reasonable
2 and fair that the Company be permitted to include those
3 carrying charges in the PPFAC.

- 4 • There could be devastating consequences for Citizens, and
5 more importantly, its customers, if Citizens' request to recover
6 these power costs is denied. The financial stability of the
7 company and its ability to provide reliable electric service to its
8 customers could be jeopardized. Such a result would be
9 contrary to the public interest.

8 **ELECTRIC DEREGULATION: THE CALIFORNIA EXPERIENCE**

9 Q. Was deregulation of the electric industry being considered during your
10 tenure as a California Commissioner?

11 A. Yes. I was a member of the CPUC during the initial phases of studying
12 electric restructuring. In February 1993, the CPUC's Division of Strategic
13 Planning issued its Perspective on the Electric Industry, Options for Reform,
14 which is also known in the industry as the "Yellow Book." In April 1994, the
15 CPUC issued its Order Instituting Rulemaking and Order Instituting
16 Investigation into Restructuring California's Electric Services Industry and
17 Reforming Regulation, (the "Blue Book"). I left the CPUC in December of
18 1994. It was not until a year later, in December of 1995, that the CPUC
19 issued its Proposed Policy Decision Adopting a Preferred Industry Structure,
20 which attempted to set out a competitive market structure for California.

21
22 Q. Would you outline the components of the California plan to restructure the
23 electric utility industry and implement retail direct access?

24 A. In December 1995, the CPUC issued its Proposed Policy Decision, which
25 called for the restructuring of the electric industry and allowed consumers
26 direct access to competitive suppliers of electric power. The CPUC created
27 the California Independent System Operator ("AISO"), whose functions
28 were to act as an electricity traffic controller and to schedule delivery of
29

1 power to match shifting demand throughout a service area that covered
2 three-quarters of the state. The Western Power Exchange ("WEPX") was
3 created as a separate market clearinghouse. Investor owned utilities
4 ("IOUs") were required to buy all their power from WEPX.

5
6 In August 1996, the Legislature enacted AB1890, which reflected much of
7 the CPUC's plan. The law required the creation of an Independent System
8 Operator to operate the transmission system and a Power Exchange to
9 operate a wholesale power market, through which the Investor Owned
10 Utilities ("IOU's") were required to buy and sell all the power needed to
11 serve their customers. The law also required IOUs to divest their power
12 plants and permitted them to recover stranded costs through a Competition
13 Transition Charge that would be on customers' bills until 2002. The law
14 also provided for a 10% rate reduction, which was financed by issuing
15 bonds that would be repaid by a charge on customers' bills over a ten-year
16 period, and a rate freeze at 1996 levels for residential customers for the
17 transition period of four years.

18
19 Q. In your opinion, what was the cause of the failure of California's
20 restructured electric industry?

21 A. Based on the review of analyses addressing the reasons the California plan
22 failed and, with 20-20 hindsight, I believe that there were a number of key
23 contributing factors to the downfall of California's restructured electric
24 industry. Fundamental problems included the short supply of generation
25 and the highly constrained transmission system. In addition, the
26 anticipated roles of the CAISO and WEPX were never realized and the rules
27 that were promulgated to address these entities were ineffective. The
28 formation of these two entities only added to the bureaucracy and
29

1 prohibited the free market from developing. There were gaping loopholes
2 in the CAISO configuration, which allowed for gaming of the system. I also
3 had concerns because the IOUs often had strong horizontal market power,
4 which resulted in the benefits of a competitive market place simply being
5 moved from one part of the electric industry to another.
6

7 **THE DOMINO EFFECT: FAILURE OF THE FLAWED CALIFORNIA PLAN**
8 **CAUSED UNPRECEDENTED INCREASES IN THE COST OF POWER IN THE**
9 **WESTERN STATES.**

10 Q. Why would the failure of California's electric restructuring plan impact the
11 western states?

12 A. The electric systems in the western part of North America are
13 interconnected directly or indirectly and are operated in parallel, pursuant
14 to a number of separate agreements among the various systems.
15 Maintaining the reliability of the system goes beyond state lines. Supply
16 and demand issues anywhere within the electric grid can impact the rest of
17 the interconnected states. The cost of electricity is impacted by supply and
18 demand. If there is a shortage of generation – due to increased usage,
19 lack of hydroelectric power, or lack of power plants - users must look other
20 places for generation.
21

22 The increased cost of power is not restricted to state boundaries; instead
23 everyone on the electric grid is impacted. When California's restructuring
24 plan left its IOU's without sufficient reserves, purchased power was at a
25 premium – for all western states, including Arizona.
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1 Q. Why didn't deregulation stimulate more available generation, instead of
2 shortages?

3 A. The marketplace incentives were supposed to replace government control,
4 but the new supply did not materialize even with the rising demand. The
5 system's uncertainties, and California's environmental fervor and slow
6 regulatory process prevented the power plants from being built and, in
7 turn, precluded the market from working.

8
9 Q. Why did Arizona, New Mexico, Southern Nevada and California have
10 concerns of being without adequate resources to accommodate their needs
11 for power?

12 A. These areas were experiencing a continuing trend of demand growth
13 exceeding the addition of new generation facilities. In a deregulated
14 system, regulators no longer have a decisive role in balancing supply and
15 demand. With its own generation supplies limited, the impact of
16 California's additional needs resulted in dramatic increases in costs for
17 power in Arizona.

18
19 **THE MAGNITUDE AND EFFECT OF THE DRAMATIC CHANGES IN THE**
20 **MARKET COULD NOT BE FORESEEN.**

21 Q. At pages 206 of his surrebuttal testimony, Staff witness Douglas Smith
22 asserts, among other things, that "Citizens should have seen a real
23 possibility for substantial price increases" in the summer of 2000. What is
24 your response to those positions?

25 A. Monday morning quarterbacking is always more accurate than pre-game
26 predictions. The reality is that during late 1999 though early 2000, no one
27 - not regulators, politicians, consumers or the industry - not even Staff or
28

1 RUCO consultants - contemplated the dramatic price spikes that began to
2 occur during the summer of 2000.

3
4 Q. Were the California Commission and/or the industry predicting the
5 possibility of skyrocketing power costs in their discussions about
6 deregulation during this time-period?

7 A. Absolutely not. In California, the very reason the CPUC had begun its
8 investigation into deregulation was as a means to cut costs. On average,
9 the cost of electricity in California was approximately 50% higher than the
10 rest of the country and electric deregulation was seen as the solution to the
11 high cost of power. The "worst case scenario" that was predicted in
12 California was the possibility that participants in deregulation would not
13 achieve the level of cost savings that had been projected.

14
15 Q. In 1995, when Citizens was negotiating what is referred to as the "Old
16 Contract," were there any indicators that the dramatic increase in power
17 costs was to be expected?

18 A. No, there was nothing occurring in the marketplace that would have
19 signaled the increase in power costs. In fact, the universal expectation was
20 that electric restructuring would lower rates.

21
22 Q. At page 7 of his surrebuttal testimony, Mr. Smith states that Citizens should
23 have been aware that there was a significant possibility that price increases
24 would be large. Do you agree?

25 A. No. Mr. Smith simply takes a few pieces of isolated data with the benefit of
26 hindsight to advance this position. Again, there were no indicators in 1999
27 or, for that matter, well into 2000 that the spikes in power costs would
28

1 occur in the summer of 2000. No individual predicted the multiple
2 conditions that converged at one time to create a "Perfect Storm" – the
3 unprecedented increase in power costs. Those conditions included:

- 4 • Political failures to address the need for bilateral contracts, *combined*
5 *with*
- 6 • The hot, smoggy summer, *combined with*
- 7 • Low hydroelectric production in the Pacific Northwest, *combined with*
- 8 • The fact that there were no significant new plants built in California
9 during the prior fifteen years, *combined with*
- 10 • Material increases in California's population, *combined with*
- 11 • Strict air quality management that required that generation plants be
12 immediately shut down if a certain level of contaminants was
13 reached, *combined with*
- 14 • Policy changes to a preference for public power over IOUs, *combined*
15 *with,*
- 16 • Further correct deductive analysis of the impact of the failed
17 California restructuring plan on the western states' power grid, as it
18 affected Arizona, Palo Verde and other western states, *combined with*
- 19 • The failure of the WEPX and the CAISO structure.

20 Like weather fronts coming together to cause a major storm, one would
21 have had to realize that all these factors were **converging at one time** in
22 order to have predicted the unprecedented price increases that took place
23 in the Western region.
24

1 Q. As a regulator, would you find that Citizens was imprudent because it failed
2 to foresee the disaster that struck the industry in the summer of 2000?

3 A. I believe that it would be patently unfair for a Commission to find a
4 company was imprudent under those circumstances. As discussed in my
5 testimony, as well as Dr. Avera's testimony, the unprecedented spikes in
6 the cost of power were not foreseen by anyone - including the government,
7 industry, and consumers. In my opinion, it would be poor public policy to
8 find that an entity had acted imprudently by failing to provide for significant
9 factors that could not be foreseen at the time the business decision was
10 made. Furthermore, under ordinary circumstances, the power supply
11 contract that Citizens executed with APS had been advantageous to
12 Citizens' customers for several years - until the bottom fell out in California
13 and the entire Western Region was detrimentally and dramatically affected
14 by California's downfall.

15
16 **CITIZENS WAS POWERLESS TO STOP OR CHANGE THE INCREASES IN**
17 **THE COST OF POWER.**

18 Q. Was there anything Citizens could have done to stop the increases
19 experienced in the summer of 2000 or to significantly mitigate the effects
20 of these increases?

21 A. No. Citizens by itself was powerless to stop the increases or mitigate the
22 effect of the rising power costs. Citizens and its rural customers were
23 caught in the tidal wave of the failure in California's restructuring plan.

24
25 Q. Do you agree with RUCO's witness, Dr. Rosen, that Citizens should have
26 filed with FERC in an attempt to stop or change the increases in the cost of
27 power?

1 A. No. Because of the political environment at the time, Citizens would have
2 been wasting its time and resources by going to FERC for a resolution.
3 RUCO's contentions that Citizens should have gone to the FERC to request
4 price caps are unreasonable. During the crisis in California, it was generally
5 known that the FERC had articulated a policy that competition in the
6 marketplace was superior to monopoly regulation and that artificial
7 government controls sent the wrong policy signals.

8
9 Furthermore, Citizens did not have the requisite size or political power to
10 have influenced FERC to adopt price caps, something that was
11 fundamentally adverse to the philosophy of the agency. Even if Citizens
12 had been involved in the FERC price cap proceeding, Citizens' involvement
13 would have had no effect on the question of whether price caps would be
14 imposed, and when such a move would occur. FERC was far more occupied
15 and concerned with the volatile California issues than it was with a small
16 distribution company in rural Arizona.

17
18 Q. Did the states affected by the demise of the California markets take any
19 action to address the problems?

20 A. Yes. In December of 2000, a regional "Energy Summit" was held to
21 address concerns that the California electricity markets could threaten the
22 Northwest power markets. Governors from five western states, the
23 Secretary of Energy and the FERC chairman met to discuss the energy
24 situation in California and the effects on the western region. The use of
25 price caps was one of the issues under discussion. The governors and the
26 Secretary of Energy advocated their use; the FERC chair argued that price
27 caps would suppress new power supply needed in the region.

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1 The only reason FERC finally did adopt price caps, which were clearly
2 against its policy, was the onslaught of political pressure from California
3 and the western states, who were reacting to the devastating impacts the
4 failure of California's deregulation scheme was having throughout the west.
5

6 Q. In your opinion, how should a company like Citizens protect itself from
7 unexpected changes in the marketplace, such as the unprecedented
8 increases in power costs?

9 A. One thing must be understood first and foremost. There is nothing a
10 company like Citizens could do to protect itself or its customers from the
11 changes in the marketplace. Clearly it is a utility's obligation to act
12 prudently for the protection of its ratepayers, as well as its shareholders.
13 However, sometimes the best-intended business decisions are impacted by
14 unknown circumstances at the time the decision was made. This is
15 particularly true when a company is trying to determine how to protect the
16 interests of both its customers and shareholders while the entire industry is
17 undergoing fundamental changes.
18

19 It is reasonable and prudent for a company to look to forecasts of the
20 experts for advice, but one must also note that forecasting is always an
21 imprecise science, and as often as not, the forecasting may be inaccurate in
22 the end. Typically when developing forecasts, one analyzes historical
23 trends and extrapolates data based on those factors and relationships.
24 However, when the electric industry was in the initial stages of
25 restructuring, and even today, there are few economic precedents or
26 historical trends upon which to base a forecast. For these reasons, it is
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1 important that companies have tools to manage the risk that is inherent
2 when there are sweeping changes occurring in the industry. Unfortunately,
3 Citizens had no safe harbor to dock in when the storm hit.

4
5 Q. As a former regulator, do you have an opinion about the Staff witnesses'
6 criticism of Citizens' failure to hedge to protect itself?

7 A. As a former regulator, I recognize the difficulties a regulated entity faces in
8 an evolving marketplace. However, hedging can be an extremely risky and
9 costly endeavor, and as a Commissioner, I would have been uncomfortable
10 letting utility companies go into the market and hedge before the
11 Commission had the opportunity to determine what safe guards should be
12 put in place before hedging would be permitted.

13
14 As a regulated utility, Citizens must comply with the mandates of the
15 Arizona Commission. As Mr. Dabelstein explained in his rebuttal testimony,
16 despite requests for guidance, the Arizona Commission has been silent
17 regarding a company's ability to utilize hedging techniques. Without
18 guidance from the Commission, I believe that Citizens acted appropriately
19 by not engaging in the use of derivative financial contracts or hedging as a
20 means of managing risk in the new marketplace.

1 **WHAT IS THE APPROPRIATE COURSE OF ACTION FOR THE COMMISSION**
2 **IN THIS CASE?**

3 Q. In your opinion, what is the appropriate standard for measuring whether
4 Citizens acted prudently in regards to the purchase of power for its
5 customers and the renegotiation of the APS contract?

6 A. In my opinion, a determination on whether conduct was reasonable and
7 prudent must be based on the facts and circumstances ***at the time the***
8 ***business decision was made.*** In this case, the dramatic and
9 unprecedented consequences resulting from the changes in the
10 marketplace were unforeseen by the government, the industry and the
11 consumers. Because these changes were not reasonably foreseeable, it is
12 clearly unfair to say that Citizens' failure to predict the startling increases in
13 the cost of power indicates that it acted imprudently.

14
15 Furthermore, the evidence shows that Citizens did indeed act prudently.
16 When the price spikes began to occur, Citizens acted quickly on a variety of
17 fronts to react to the problem. Ultimately, Citizens negotiated a contract
18 that provided long-term stability in rates for its customers at a reasonable
19 price. Throughout this entire time period, Citizens did what it was
20 supposed to do, including paying APS out of its own pockets so its
21 customers would have electricity. In an unregulated industry, this would
22 not have been required – instead the costs would have been passed directly
23 on to customers. The appropriate and equitable decision in this case is to
24 allow Citizens to recover the money it has spent to keep the lights on for its
25 customers.

1 Q. Should the Commission mandate that Citizens litigate the contract dispute
2 with APS at FERC, as both the Staff and RUCO witnesses continue to assert
3 on surrebuttal?

4 A. Staff's and RUCO's insistence that Citizens should now file or should have
5 filed with the FERC for resolution of Citizens' contract issues would place
6 the Arizona Commission in a position of second guessing a clearly
7 reasonable management decision. Citizens' decision to negotiate rather
8 than litigate was made thoughtfully and deliberately. Citizens has
9 presented evidence that over many months, it carefully analyzed the
10 situation, consulted with lawyers and experts as to the potential outcome
11 and the length of time contemplated to reach resolution by filing litigation,
12 either at FERC or in the courts, and finally made an appropriate business
13 decision that it was more realistic to try to negotiate with APS than to
14 litigate.

15
16 Citizens had legitimate reasons in taking this approach. It faced a
17 formidable opponent in what appeared to be a less than friendly forum, and
18 litigation is a protracted and expensive process, during which time, the
19 hemorrhaging with costs continuing to accrue every month would continue.
20 If litigation were pursued, both the company and its customers would have
21 remained at the mercy of the market, with no stability to their rates and no
22 certainty on outcome. Citizens made a prudent business decision in light of
23 all these factors. It is inappropriate for a regulatory body to substitute its
24 judgment for the company's when the company has acted prudently and
25 judiciously. As to pursuing the issue now, Mr. Flynn describes the problems
26 with the case. I would just add that the FERC probably would not be
27 motivated to adjudicate a contract that has been replaced by a new
28 agreement.

1 Q. As a former Commissioner, what is your opinion as to the appropriate
2 approach to determine the correct result in this particular case?

3 A. Clearly this is a difficult case because of the magnitude of the costs
4 involved. However, despite the boxes of documents that have been
5 reviewed in this matter, it boils down to a fairly simple case: Power costs
6 spiked in an unexpected and unprecedented way in the summer of 2000
7 and under its power supply contract, Citizens had to bear the brunt of those
8 cost increases. Citizens paid millions of dollars for power to insure that its
9 customers had electricity to run their air conditioners and to keep their
10 lights on. The customers have already used that power. Citizens has made
11 absolutely no profit and will make no profit on the power costs it seeks to
12 recover in this proceeding. In fact, Citizens has already suffered millions in
13 losses for covering the shortfall.

14
15 The Arizona Commission must find the fairest and least painful way to
16 reimburse Citizens for the cost of power. Citizens has proposed to mitigate
17 the rate shock by amortizing the amount over a seven-year period. As a
18 former Commissioner, I believe that this is an equitable approach and
19 should be adopted.

20
21 This Commission should also be mindful of the carrying costs for the \$87.7
22 million dollars at issue in this matter. It is only fair that Citizens be allowed
23 to recover a reasonable carrying charge, particularly because the company
24 will continue to carry these costs for an additional seven years if its
25 proposal is accepted.

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1 **THE HARSH REALITY: THERE ARE SIGNIFICANT ADVERSE**
2 **CONSEQUENCES IF THE ARIZONA COMMISSION REFUSES TO ALLOW**
3 **RECOVERY IN THIS MATTER.**

4 Q. Why shouldn't this Commission let the shareholders rather than the
5 customers pay for the unexpected and expensive power costs?

6 A. From a regulatory and political perspective, denying Citizens recovery may
7 be attractive, at first blush. It is never easy for a public official to be in a
8 position of passing costs on to the public. I would assume that this is even
9 more difficult when you are an elected official and your decision will have a
10 direct effect on your constituents.

11
12 However, if the Arizona Commission were to deny recovery to Citizens for
13 the increased cost of power, where Citizens was neither the cause of the
14 market place changes that resulted in unprecedented power costs, nor able
15 to do anything to "fix" the problem, the effect of that decision would be felt
16 statewide, and into the future. Not only would Citizens be hampered in its
17 ability to obtain capital, but other Arizona utilities could also face reluctance
18 on the part of investors and lenders, who may be "chilled" by the approach
19 of the Arizona Commission in denying legitimate power cost recovery. Such
20 a decision has the potential of discouraging economic development within
21 the state - particularly in those rural areas where Citizens serves. This is
22 not good for the customers or the state.

23
24 If Citizens' Arizona Electric Division was a stand-alone company and had to
25 carry the magnitude of costs involved in this matter, it would be in
26 bankruptcy. The fact that the Arizona Electric Division is a division of a
27 much larger company, as required by the federal Public Utilities Holding
28 Company Act ("PUHCA"), should not change the way the Arizona
29

1 Commission responds to the urgency of this situation. A signal that the
2 state would deny the recovery of costs to a regulated company that has
3 legitimately incurred those costs is a signal that the State of Arizona does
4 not treat business in a fair and equitable manner. This is clearly contrary to
5 the public interest.

6
7 Q. Didn't the CPUC reject PG&E's request that the CPUC come to its rescue
8 when the company's financial viability became questionable?

9 A. Yes. One must realize that Citizens is in a materially different situation
10 than either of the two California companies. SoCal Edison and PG&E had
11 been allowed to recover the value of stranded plant, in exchange for rate
12 freeze for residential customers until 2002. This was the new regulatory
13 compact: stranded cost pay out in exchange for rate freeze until 2002.

14
15 Q. How are the requests for assistance from the CPUC by PG&E any different
16 than the request by Citizens for a surcharge to recover unprecedented
17 power costs from its customers?

18 A. Citizens' request is not even remotely similar. Citizens paid the power
19 costs for its customers, made no profits on the higher cost of power, and it
20 has no rate freeze in place. PG&E had a "quid pro quo" - it received
21 stranded cost in exchange for the rate freeze ("something for something").
22 Citizens had neither a quid nor a quo- it received nothing in exchange for
23 paying for the purchased power. To attempt to compare the CPUC actions
24 to Citizens request before the Arizona Commission is fruitless.

25
26 To deny recovery to Citizens would in effect communicating that the
27 Commission is unconcerned with the effect of its decisions on the viability
28 of a utility company. One must take into consideration two factors: (1)

1 electric service is a necessity of life, particularly in those areas of the state
2 where temperatures are so extreme that people could die without air
3 conditioning; and (2) Citizens serves the customers in the rural areas of
4 Arizona, places where it would be difficult to find other providers to serve
5 because of the geography and smaller populations. To jeopardize a
6 company's financial position clearly runs contrary to the interest of the
7 customers and to the interests of the state.

8
9 Q. Does this conclude your testimony?

10 A. Yes.

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PATRICIA M. ECKERT

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(415) 771-8575

San Francisco, California 94123
Fax: (415) 771-0373

Patricia M. Eckert is an industry consultant providing regulatory advisory and business development services to a number of clients in the telecommunications and utilities industries.

Ms. Eckert is the former President of the California Public Utilities Commission (CPUC) and a Commissioner from 1989 through 1994. The CPUC is one of the largest economic regulatory bodies in the United States, overseeing \$50 billion of rates and services annually. Ms. Eckert was appointed to the CPUC by Governor George Deukmejian in 1989. As President, she oversaw implementation of local exchange competition policy and rules. Ms. Eckert has consistently advanced the architecture of the New Regulatory Framework of incentive-based telephony regulation and developed policies designed to enhance California's competitiveness within the global telecommunications infrastructure. During her tenure with the CPUC, Ms. Eckert initiated a comprehensive review of California's electric utility industry and is an initial architect of California's electric industry restructuring.

In recent years, Ms. Eckert has focused on advising Fortune 100 clients on a variety of regulatory and partnering issues. One particular area of expertise is facilitating strategic alliances in the California markets, with a specialty in telecommunications-electricity crossover and wireless communications.

In 1995, the consulting firm of Deloitte & Touche (D&T) retained Ms. Eckert as a strategic partner. In that capacity, Ms. Eckert played a key role in the launch of D&T's emerging telecom industry practice; D&T's telecom practice grew exponentially. Serving as a consultant, she was also Advisor, Office of the President of Stanford Research International Consulting (SRIC) in 1998-99.

In 1982, Ms. Eckert established the Beverly Hills law firm of Eckert & Colman, which specialized in business transactions, real estate, and taxation. Her law practice expanded to include complex federal litigation involving United States defense contract matters.

Before entering private law practice, Ms. Eckert worked for more than 14 years as a business and marketing executive for Procter & Gamble and The Dow Chemical Company and Bio-Science Laboratories.

A member of the State Bar of California, Ms. Eckert has served on the State Bar of California's Commission on Judicial Nominees Evaluation. In 1987, Ms. Eckert was a gubernatorial appointee to the Dispute Resolution Advisory Council.

Ms. Eckert served as Chairman of the National Association of Regulatory Commissioners (NARUC) Committee on Administration. She was also a member of NARUC's Electricity and International Committees and the Western Conference of Public Service Commissioners. She served on the Board of Directors of Rebuild LA and is currently a member of the Board of Directors of Dynegy. She also serves on the advisory boards of EnerTech Capital Partners.

Ms. Eckert graduated Phi Kappa Phi *cum laude* with a degree in business from Parsons College and holds a Juris Doctor Degree from Loyola Law School in Los Angeles.

PUBLICATIONS

California's Vision, PUBLIC UTILITIES FORTNIGHTLY (November 1, 1993).

Learning from Public/Private Dialogues, PUBLIC UTILITIES FORTNIGHTLY (November 1, 1991).

Customer Service – The New Competitive Edge?, PUBLIC UTILITIES FORTNIGHTLY (November 1, 1991).

Symbols of Change – California's Vision, CONNECTIONS (July/August 1991).

QUOTED IN

WALL STREET JOURNAL (energy efficiency), NEW YORK TIMES (energy), LOS ANGELES TIMES, THE CALGARY HERALD, FINANCIAL POST, THE SAN DIEGO UNION, GLOBE AND MAIL, SAN FRANCISCO EXAMINER, SAN FRANCISCO CHRONICLE, OAKLAND TRIBUNE.

PRESENTATIONS

Presented at national and international conferences (12 to 16 annually); topics include California regulation, electricity derivatives and risk management, telecom crossover opportunities for utilities, Aspen Institute Global and Energy conferences attended.

SPEAKING ENGAGEMENTS**[Current]**

APERC (Asia Pacific Energy Research Council)
Tokyo, Japan

Gulf Coast Power Association
Austin, Texas

[While serving as CPUC Commissioner]

May 11, 1994	CS First Boston 1994 Electric Utilities Conference (Opportunities and Risks in a Changing Market) New York, NY
May 5, 1994	Association for Local Telecommunications Services (Red Light, Green Light: The States versus the Federal Government in the Encouragement of Local Competition) Washington, D.C.
April 22, 1992	New York Mercantile Exchange (Managing Energy Price Risk) New York, NY
March 17, 1994	The Keystone Center Meeting on Use of Gas for Electricity Generation (California's Perspective) Jackson Hole, WY
March 15, 1994	Bear, Stearns & Co., Inc. Latin American Utility Conference (California's Electric and Natural Gas Industries) Buenos Aires, Argentina
February 18, 1994	University of Southern California Center for Telecommunications Management (1994 Executive Round Table: Convergence and Alliance)
February 10, 1994	Gas Daily: Advanced Hedging With Futures, Options and Other Methods. Houston, Texas.
February 4, 1994	Investigation of the Communications Infrastructure of the State of Hawaii (Infrastructure Modernization Deployment Timeframes) Honolulu, Hawaii.
February 1, 1994	Telestrategies Conference/Local Exchange Competition (The Regulatory Outlook: Defining Local Competition) Washington, D.C.
October 25, 1993	The 2 nd Annual New Construction Programs for DSM Conference. San Diego, California
September 20, 1993	Natural Gas Futures Conference (Risk Management for the Natural Gas Industry) Houston, Texas

August 31, 1993	Telecommunications Committee of the L.A. Chamber of Commerce (Building Tomorrow's Infrastructure: The Competitive Global Market) Los Angeles, California
July 20, 1993	Telestrategies Conference/Local Exchange Competition (California Initiatives, Interconnection and Switched Access) Washington, D.C.
July 15, 1993	National Regulatory Research Institute (Public Utility Implementation of the Energy Policy Act of 1992). Portland, Oregon.
June 24, 1993	Infocast (Performance Contracting for Demand-Side Management) San Francisco, California
June 10, 1993	Europe-United States Meetings D.G. XIII (Cooperation and Competition in Telecommunications) Rome, Italy.
May 2, 1993	University of Southern California Center for Telecommunications Management (Keynote address – British Telecom executive program) Newport Beach, California.
March 17, 1993	New Mexico State University Center for Public Utilities (Changing Relationship Between Electric Utilities and Natural Gas Utilities) Santa Fe, New Mexico.
February 27, 1993	Alliance for Public Technology (Regulatory Requirements for Achieving Equity in the Twenty-First Century) Washington, D.C.
February 19, 1993	University of Southern California Center for Telecommunications Management (1993 Executive Round Table) Santa Barbara, California
February 11, 1993	California Utility Research Council (Annual Meeting) Irvine, California
January 28, 1993	Power Engineering -- Electric Light and Power (Transmission Reform & PUHCA Marketing Opportunities) San Francisco, California
January 25, 1993	Los Angeles Power Producers Association (Natural Gas Procurement in California) Los Angeles, California
January 6, 1993	University of Southern California Center for Telecommunications Management (International Infrastructure Study) Los Angeles, California.
November 2, 1992	Barclay's Bank Luncheon. New York, New York.

- September 10, 1992 American Hunter Energy. Annual Conference. San Diego, California
- August 11, 1992 American Bar Association (Public Utility Section) (Transition Planning for Electric Transmission) San Francisco, California.
- May 29, 1992 Psomas and Associates. Los Angeles, California.
- May 21, 1992 Federal Energy Bar Association (FEBA) (Incentive Ratemaking) Washington, D.C.
- May 13, 1992 Southern California Edison Press Conference. (Rebuild L.A.) Compton, California.
- March 26, 1992 Globalcon '92 (Energy and the Environment) San Jose, California
- March 9, 1992 Role of Markets in Regulated Industries. Santa Fe, New Mexico.
- February 19, 1992 Association of Gas Distributors (Coping with State and Federal Gas Regulation) Stuart, Florida.
- February 13, 1992 Independent Petroleum Association of Mountain States (Natural Gas Market in California) Denver, Colorado.
- January 23, 1992 Jesse M. Unruh Institute of Politics – University of Southern California (NAFTA's Impact on California) Los Angeles, California
- November 19, 1991 Executive Enterprises, Inc. (The Bold New World of Capacity Brokering) San Francisco, California.
- November 12, 1991 17th Annual LA Chamber of Conference Century of the Pacific Conference (Demand Side Management) Santa Monica, California.
- October 7, 1991 Pacific Gas and Electric/General Motors (Natural Gas Vehicles) San Francisco, California.
- September 20, 1991 Ernst and Young; Electricity & Gas Symposium 1991 (How to Make Decisions in a Highly Regulated Gas Market) Silverado Country Club-Napa, California.
- September 17, 1991 FERC Technical Conference on Capacity Brokering (Opening Statement) Washington, D.C.
- August 2, 1991 California Energy Coalition (Customers, Empower Yourself) Newport Beach, California.

July 3, 1991 Calgary Society of Financial Analysts (Natural Gas Market in California) Calgary, Canada.

June 24, 1991 NARUC Western Conference of Public Service Commissioners (Customer Service) Kailua, Hawaii.

May 20, 1991 CA Independent Petroleum Association 15th Annual Meeting (California Natural Gas Market) San Francisco, California.

April 4, 1991 5th Annual Spring Symposium on Natural Gas (California Natural Gas Market) San Diego, California.

February 20, 1991 PG&E Board of Directors (Energy and the Environment) San Francisco, California.

February 17, 1991 California Telephone Association (Competition in the Telecommunications Industry) Monterey, California.

February 11, 1991 Natural Gas Transportation Association (California Natural Gas Market) San Diego, California.

January 14, 1991 Executive Enterprises – 9th Annual Conference (California Natural Gas Market) San Francisco, California.

October 15, 1990 California Clear Air Technologies Conference (Air Quality) Los Angeles, California.

March 22, 1990 Pacific Coast Electrical Association (Competition, Regulation, and Quality) San Francisco, California

March 20, 1990 California Manufacturers Association (Energy and the Environment) Sacramento, California.

November 17, 1989 Regulatory Research Associates for Financial Analysts (Regulatory Philosophies) New York, New York

September 21, 1989 Conference of California Public Utility Counsel (Regulatory Outlook) San Francisco, California.

LEGISLATIVE TESTIMONY

May 2, 1991 House subcommittee on Energy and Power (National Energy Strategy, Public Utility Holding Company Act (PUHCA) Reform) Washington, D.C.

April 22, 1991 Joint Committee on Energy Regulation & the Environment (SCR-7 Testimony) Sacramento, California.

April 9, 1991 Senate Committee on Energy and Public Utilities (Hearing on SB 1041 & SB 1042) Sacramento, California.

- March 14, 1991 Senate Committee on Energy and Natural Resources (Public Utilities Holding Company Act (PUHCA) Reform)
Washington, D.C.
- October 30, 1992 Congressional Commission on Infrastructure Investment
(Telecommunications Infrastructure Investment)
Washington, D.C.

EDUCATIONAL SEMINARS PRESENTED

- September, 1992 University of Southern California
Center for Telecommunications Management, Advanced
Management Seminar
Los Angeles, California
- March, 1992 New Mexico State University
Center for Public Services
Santa Fe, New Mexico

1
2 **REJOINDER TESTIMONY**
3 **OF**
4 **THOMAS J. FERRY**
5 **CITIZENS COMMUNICATIONS COMPANY**
6 **ARIZONA ELECTRIC DIVISION**

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9 **DOCKET NO. E-01032C-00-0751**

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26 **MARCH 19, 2002**
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1 Q. Please state your name and business address.

2 A. My name is Thomas J. Ferry. My business address is Citizens
3 Communications Company Arizona Electric, 2498 Airway Ave., Kingman,
4 Arizona 86401.

5
6 Q. Are you the same Thomas J. Ferry who previously submitted direct
7 testimony in this case?

8 A. Yes, I am.

9
10 Q. What is the purpose of your rejoinder testimony?

11 A. The purpose of my rejoinder testimony is to respond to the surrebuttal
12 testimony of Marshall Magruder.

13
14 Q. Please summarize your testimony.

15 A. In response to Mr. Magruder's questions, I will describe the efforts made by
16 Citizens to inform customers about the PPFAC application and to encourage
17 certain DSM and energy conservation efforts.

18
19 Q. Please provide your responses to Mr. Magruder's questions.

20 A. The questions and my responses are as follows:

21 **1. When will Citizens establish a DSM?**

22 Pursuant to the Arizona Corporation Commission ("Commission")
23 Order in Docket No.'s E-1032-92-073 (dated August 23, 1993) and E-
24 1032-94-214 (dated February 25, 1995), Citizens first implemented
25 DSM programs on June 1, 1994. Since that date, nearly 3,000 have
26 participated in the program. Citizens' Arizona Electric Division has
27 achieved and reported to the Commission energy and demand
28 savings of nearly 17,000 MWh/yr and 5,500 kW respectively.

29

1 **2. Why are there very few incentives in the present "DSM**
2 **conservation program?**

3 The nature and extent of DSM programs employed by Citizens reflect
4 the extent of funding authorized by the Commission. All DSM
5 programs must be pre-approved by the Commission Staff. Citizens
6 approach to DSM limited the use of financial incentives to customers
7 to participate. (Docket No. E-1032-94-214, Decision 58984, Feb. 24,
8 1995, page 2, lines 9-11, 16-19). The Commission determined that
9 on-going DSM programs should be funded at \$175,000 annually.
10 (Docket Nos. E-1032-95-433 and E-1032-95-040, Decision No
11 59951, Jan. 3, 1997, page 27, lines 24 and 28).

12
13 **3. When will Citizens permit distributed generation ("DG")**
14 **sources to join in their local grids?**

15 Citizens allows the connection of DG facilities to the grid. Some
16 customers already own and operate onsite generation equipment.

17
18 **4. Has Citizens done anything to encourage DG in its service**
19 **area?**

20 Citizens has Commission-approved Qualifying Facilities ("QF") tariffs
21 in place that allow DG facilities in its service area. Moreover,
22 Company representatives have worked with local government
23 agencies to install distributed generation facilities in order to take
24 advantage of Citizens' Interruptible Power Service rate.

25
26 **5. When will residential DSM techniques be implemented?**

27 Residential DSM was implemented in 1994 at the same time as
28 Citizens' DSM programs for other customer classes. More than 2,100
29

1 residential customers have participated in the programs. Residential
2 customers have achieved energy and demand savings of nearly 7,000
3 MWh/yr and over 3,300 kW respectively.
4

5 **6. When will "peak demand" be considered as the basis for DSM**
6 **decisions?**

7 Peak demand is one of the criteria established by the Commission for
8 evaluating DSM decisions. Citizens' requests for Commission Pre-
9 Approval of DSM programs include a section titled "Cost Benefit
10 Analysis and Assumptions". Demand (KW) reduction at time of
11 system peak or "peak demand" is a key factor in the comparison of
12 program benefits and costs.
13

14 **7. When will "load-shaping" be understood and implemented by**
15 **Citizens?**

16 It is unclear what Mr. Magruder means by "load-shaping". Citizens'
17 cost-benefit analysis of DSM programs appropriately considers the
18 resulting reduction in kW at the time of system peak. This results in
19 DSM measures that aid in reducing the system load, particularly at
20 the time of system peak. Citizens' Large General Service ("LGS") and
21 Large Power Service ("LPS") rates include incentives for customers to
22 shift load to off peak periods.
23

24 Q. What efforts has Citizens undertaken to inform customers about the PPFAC
25 application and its likely impact on them?

26 A. During the summer of 2000, Citizens initiated a public information
27 campaign to inform customers of the high wholesale power costs being
28 incurred by the Company, and to encourage them to adopt conservation
29

1 measures in order to mitigate the financial impact on them. In addition,
2 meetings were held with the largest commercial and industrial customers to
3 make certain they were aware of the potential bill impacts, and to assist
4 them in identifying actions that could be taken to conserve energy.
5

6 Q. Can you site specific examples of these customer contacts?

7 A. Yes I can. Nearly 50 of the largest customers were individually visited in
8 August 2000 as part of our public information campaign. Since then, nearly
9 100 presentations have been made to individual customers or groups.
10 Such activities are summarized on accompanying Exhibit TJF-1. All of the
11 school districts in the communities in which we serve were contacted and
12 extensive energy audits scheduled for each of their facilities. Many of the
13 customers have considered the recommendations arising from the energy
14 audits and have proceeded to implement them, such as lighting and air
15 conditioning upgrades. We have performed extensive follow up by
16 contacting the customers on several occasions since the completion of the
17 audits to update them on DSM initiatives offered by Citizens.
18

19 As an example of our efforts, a special Voluntary Load Curtailment tariff
20 was created to encourage the reduction of energy use during periods of
21 high prices. School administration personnel were contacted to discuss how
22 they could modify summer work schedules to reduce loads during high cost
23 energy times. Load patterns at individual buildings were analyzed to
24 determine if summer use could be curtailed.
25
26
27
28
29

1 The air conditioner replacement programs in late 2000 and early 2002 were
2 offered to the schools. The school districts in Lake Havasu and Kingman
3 have identified units that will be replaced as part of our upgrade program
4 currently underway.

5
6 Sterilite Industries, our largest single customer in Lake Havasu, has decided
7 to proceed with our recommended on-site improvements so they can take
8 advantage of cost savings available to them by switching to our Large
9 Power Service transmission level tariff.

10
11 Equatorial Minerals in Kingman has initiated a demand shaving program,
12 which has affectively reduced their kW peak. Citizens has replaced
13 Equatorial's metering to give them the capability to monitor their load
14 instantaneously. We also have made recommendations on control
15 equipment, which can be installed to automatically control certain loads in
16 order to avoid new peaks. Citizens has committed to support Equatorial's
17 request to reset their billing demand based on their DSM efforts.

18
19 As may be inferred from the foregoing, Citizens has kept its customers
20 informed and has aggressively pursued energy conservation activities.

21
22 Q. Does this conclude your rebuttal testimony?

23 A. Yes it does.

24
25
26
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EXHIBIT A

CUSTOMER CONTACTS

BUSINESS NAME	BUSINESS CONTACT	DATE	CONTACTED BY	COMMENTS
City of Kingman	Mayor Les Byram & City Manager, Lou Sorenson	08/14/00	Tom Ferry	
City of Lake Havasu	Mayor Melanie Grinstead-Hanak & City Manager, Bruce Williams	08/14/00	Tom Ferry & Bud Haas	
Mohave County Supervisor	Carol Anderson	08/14/00	Tom Ferry	
Mohave County Supervisor	Buster Johnson	08/15/00	Bud Haas	
State Representative	Joe Hart	08/15/00	Tom Ferry	
Mohave County Economic Development Authority	Bill Goodale	08/15/00	Dan McCarthy & Tom Ferry	
Sterilite	Dave Marshall	08/15/00	Bud Haas	928-453-5060
LHC Unified School District	Dr. Joseph Meli	08/15/00	Bud Haas	928-855-7861
Havasut Samaritan Regional Hospital	Mike Edubule	08/15/00	Bud Haas	928-855-8185
Eyes of Arizona	Tim Kramer	08/16/00	Bud Haas	
Partnership for Economic Development	Robert Tippett	08/16/00	Bud Haas	928-505-7333
K-Mart (LHC)	Larry McDonald	08/16/00	Bud Haas	928-453-5919
Candidate for Mohave County Supervisor	Pat Bourque	08/18/00	Tom Ferry	
Sterris Isomedix (formerly Deroval Sterilization)	John Valukas	08/18/00	Ernie Ojeda	
Badger Meter	Rick Clayton	08/18/00	Ernie Ojeda	
BICC General (General Cable)	Greg Testa	08/21/00	Tom Ferry	928-757-0404
Kingman Elementary School District	Barlow Quinton	08/21/00	Bud Haas & Paula Sparks	
Ivy Steel & Wire (Hallett)	Mark Stojevich, Div. Mgr.	08/21/00	Bud Haas & Paula Sparks	
Potter Industries	Joe Schuda, Corporate Headquarters	08/21/00	Paula Sparks	
United Musical Instruments	Patrick Neal	08/21/00	Ernie Ojeda	
Candidate for Mohave County Supervisor	Pete Byers	08/21/00	Tom Ferry	
Summit Window & Patio	Rodney Rich, Prod. Mgr.	08/22/00	Bud Haas & Paula Sparks	

EXHIBIT A

CUSTOMER CONTACTS

BUSINESS NAME	BUSINESS CONTACT	DATE	CONTACTED BY	COMMENTS
Mohave County Union High School	Mike Ford, Superintendent	08/22/00	Bud Haas & Paula Sparks	
MCEDA	Bill Goodale	08/22/00	Tom Ferry	
Tru Serv (Cotter & Company)	Don Fuller	08/22/00	Tom Ferry	
Quail Piping	Charles Johnson, Dir. Of Oper.	08/22/00	Bud Haas & Paula Sparks	
Rio Rico Resort	John O'Hara	08/22/00	Ernie Ojeda	
Santa Cruz County School District	Bob Canchola	08/23/00	Ernie Ojeda	
MCEDA President	Henry Varga	08/24/00	Tom Ferry	
Nogales Chamber of Commerce	Board of Directors	08/24/00	Ernie Ojeda	
Nogales Sewage Treatment Plant	?	08/25/00	Ernie Ojeda	
Western Area Council of Governments (WACOG)	Dave Barber	08/25/00	Tom Ferry	
Route 66 Rotary	Club Program	08/25/00	Bud Haas	
International Boundary and Water Commission (Sewage Treatment Plant)	Steve Tencza	08/25/00	Ernie Ojeda	
McDonald's	Jose Canchola	08/25/00	Ernie Ojeda	
Goodyear Airtreads	Tim Frosell, Plant Manager	08/25/00	Paula Sparks	
Havasu Chamber of Commerce	Gary Powers	08/25/00	Bud Haas	
Mohave County Manager	Dick Skalicky	08/28/00	Tom Ferry	
Salvation Army	Lt. Dee Dee Lively	08/28/00	Bud Haas	
City of Kingman	Mayor Byram	08/29/00	Tom Ferry	
American Woodmark	Tom McLarty	08/29/00	Tom Ferry	
Kingman Regional Medical Center (KRMCC)	Brian Turney	08/29/00	Tom Ferry	928-757-0602
CUC Gas	Scott McKnight	08/29/00	Tom Ferry	
Summit Window & Patio	Rodney Rich, Prod. Mgr.	08/29/00	Paula Sparks	

EXHIBIT A

CUSTOMER CONTACTS

BUSINESS NAME	BUSINESS CONTACT	DATE	CONTACTED BY	COMMENTS
St. Vincent's	Margaret Repasky	08/29/00	Bud Haas	
Kingman Rotary	Club Program	08/30/00	Bud Haas & Tom Ferry	
Western Area Council of Governments (WACOG)	Dave Barber	08/31/00	Tom Ferry	
Potter Industries	Joe Schuda, Corporate Headquarters	08/31/00	Paula Sparks	
Guardian	Bill McNally (Consultant)	09/01/00	Sean Breen	
Mohave County Supervisor	Carol Anderson	09/28/00	Tom Ferry	Left Message
City of Kingman	Lou Sorenson, City Manager	09/29/00	Tom Ferry	Requested Future Audit - 928-753-5561
Mohave County Economic Development Authority	Bill Goodale	09/29/00	Tom Ferry	
BICC General (General Cable)	Greg Testa	09/29/00	Tom Ferry	
Western Area Council of Governments (WACOG)	Dave Barber	09/29/00	Tom Ferry	Left Message
City of Kingman	Les Byram	09/29/00	Tom Ferry	Left Message
Equatorial	Joey Mathews	09/29/00	Tom Ferry	They are in the process of selling & this could effect the deal. 928-565-2226 Ext. 23
Ivy Steel & Wire (Hallett)	Mark Stojevich, Div. Mgr.	10/03/00	Paula Sparks	
Summit Window & Patio	Rick Campbell, Plant Manager	10/03/00	Paula Sparks	
Goodyear Airtreads	Tim Frosell, Plant Manager	10/03/00	Paula Sparks	
Mohave County Manager	Dick Skalicky	10/03/00	Tom Ferry	Requested Future Audit
Quail Piping	Charles Johnson, Dir. Of Oper.	10/03/00	Paula Sparks	928-692-8400
Mohave County Union High School	Mike Ford, Superintendent	10/04/00	Tom Ferry	Requested Future Audit
Mohave County Union High School	Mike Ford, Superintendent	10/04/00	Tom Ferry	Requested Future Audit
The Gardens Care Center	Matthew Myers	10/04/00	Tom Ferry	Requested Future Audit
Williams Travel Center	Mike Reed	10/06/00	Paula Sparks	Pre Construction Audit

EXHIBIT A

CUSTOMER CONTACTS

BUSINESS NAME	BUSINESS CONTACT	DATE	CONTACTED BY	COMMENTS
Western Area Council of Governments (WACOG)	Dave Barber	10/06/00	Tom Ferry	CARES participation is at 30%
Canyon Distributers	Tom Clark	10/11/00	Tom Ferry	Expansion Review - Audit
Dambar Restaurant	Krystal Burge	10/11/00	Tom Ferry	Audit
Kingman Chamber of Commerce	Board of Directors	10/11/00	Tom Ferry	
General Cable	Greg Testa	11/09/00	Tom Ferry	Left Message
Equatorial	Joey Mathews	11/09/00	Tom Ferry	Left Message
City of Kingman	Lou Sorenson, City Manager	11/09/00	Tom Ferry	
City of Lake Havasu	Bruce Williams, City Manager	11/09/00	Tom Ferry	Left Message
Mohave County Supervisor	Buster Johnson	11/09/00	Tom Ferry	Left Message
Mohave County Economic Development Authority	Bill Goodale	11/09/00	Tom Ferry	692-6970
Mohave County Superintendent	Mike File	12/12/00	Tom Ferry	Discussed status of requested ppfac increase
Kingman Consolidated Superintendent of Schools	Mike Ford	12/12/00	Tom Ferry	Discussed status of requested ppfac increase
Lake Havasu Superintendent of Schools	Joe Malley	12/12/00	Tom Ferry	Discussed status of requested ppfac increase
Administrative Assistant Lake Havasu Schools	Missy Woods	12/12/00	Tom Ferry	Discussed status of requested ppfac increase
Chloride Superintendent of Schools	Jim Waland	12/12/00	Tom Ferry	Discussed status of requested ppfac increase
Mohave Education Services	Dave Wasson	12/12/00	Tom Ferry	Discussed status of requested ppfac increase
Dominion Prison (Future)	Jim Hunter	01/04/01	Tom Ferry	Industrial Prospect
City of Nogales	Mayor Marco Lopez	02/09/01	Tom Ferry & Ernie Ojeda	
Sterilite	David Marshall	02/14/01	Tom Ferry	
City of Kingman	Jack Kramer, Scott Yocum	02/15/01	Tom Ferry	Interruptibles Review
Ford Proving Grounds	Valerie Ronchetto	02/27/01	Tom Ferry	
City of Kingman	Mayor Les Byram	03/01/01	Tom Ferry	

EXHIBIT A

CUSTOMER CONTACTS

BUSINESS NAME	BUSINESS CONTACT	DATE	CONTACTED BY	COMMENTS
Kingman Regional Medical Center (KRMCC)	Steve Shite, John Seleguini	03/03/01	Tom Ferry	DSM & Generator Use
Mohave County Supervisor	Pete Byers	03/05/01	Tom Ferry	
Mohave County Supervisor	Pete Byers	03/07/01	Tom Ferry	
Lake Havasu Energy Seminar		04/19/01	Tom Ferry	
Ivy Steel & Wire (Hallett)		04/30/01	Tom Ferry	
New Prospect for Tucker Building		05/18/01	Tom Ferry	
City of Kingman	Lou Sorenson, City Manager	05/22/01	Tom Ferry	
Load Curtailment Meeting		05/23/01	Tom Ferry	
Voluntary Curtailment Luncheon		05/25/01	Tom Ferry	
City of Kingman	Councilman Dave French	06/07/01	Tom Ferry	
City of Kingman	Councilman Dave French	06/11/01	Tom Ferry	
Mohave County Economic Development Authority	Bill Goodale	06/13/01	Tom Ferry	
Department of Economic Security		06/14/01	Tom Ferry	Cares Program
City of Nogales	Mayor Marco Lopez	09/07/01	Tom Ferry	
Southwire	Phil Tuggle	09/20/01	Paula Baxter	
Guardian Fiberglass	Nicole	09/20/01	Paula Baxter	
Equatorial	Joey Mathews	09/20/01	Paula Baxter	
Sterilite	Dave Marshall	09/20/01	Paula Baxter	
Ford Proving Grounds	Valerie Ronchetto	09/20/01	Paula Baxter	
Ivy Steel & Wire (Hallett)	Mark Stojevich, Div. Mgr.	09/20/01	Paula Baxter	
General Cable	Greg Testa	09/20/01	Paula Baxter	
Quail Piping	Charles Johnson, Dir. Of Oper.	09/20/01	Paula Baxter	

EXHIBIT A

CUSTOMER CONTACTS

BUSINESS NAME	BUSINESS CONTACT	DATE	CONTACTED BY	COMMENTS
Equatorial Mineral Park	Joey Mathews	10/02/01	Tom Ferry	Suggested load management system and committed demand reset.
General Cable	Jim Perdue & Greg Testa	10/02/01	Tom Ferry	Suggested load management system and committed demand reset.
Mohave County Supervisor	Pete Byers	10/19/01	Tom Ferry	
City of Lake Havasu	Bruce Williams, City Manager	10/29/01	Tom Ferry	
Lake Havasu Partnership for Economic Development	Ron Holbrook	10/30/01	Tom Ferry	
Mohave County Supervisor	Tom Sockwell	10/31/01	Tom Ferry	Phone Conversation
Mohave County Supervisor	Buster Johnson	11/07/01	Tom Ferry	Left Message
State Representative	Linda Bender	11/07/01	Tom Ferry	
City of Kingman	Mayor Les Byram	11/09/01	Tom Ferry	
City of Kingman	Lou Sorenson, City Manager	11/09/01	Tom Ferry	753-5561
Sterilite	Dave Marshall	11/09/01	Tom Ferry	
Quail Piping	Charles Johnson, Dir. Of Oper.	11/10/01	Tom Ferry	692-8400
Sterilite	David Marshall	11/12/01	Tom Ferry	
Route 66 Rotary	Club Presentation	11/16/01	Tom Ferry	
Kingman Area Chamber of Commerce	Krystal Burge	12/06/01	Tom Ferry	PPFAC
Taco Bell Franchise	Krystal Burge	12/06/01	Tom Ferry	PPFAC
Kingman Area Chamber of Commerce	Board of Directors	12/12/01	Tom Ferry	
Help Us Get Good Government (H.U.G.G.G.)	Club Presentation	12/13/01	Tom Ferry	
Kingman Regional Medical Center (KRMC)	Brian Turney	01/08/02	Tom Ferry	PPFAC
Santa Cruz County	Greg Lucero, County Manager	01/18/02	Ernesto Ojeda	
Kingman Regional Medical Center (KRMC)	Board of Directors	01/22/02	Tom Ferry	
Equatorial	Mike Kondelis & Joey Matthews	01/28/02	Tom Ferry & Paula Baxter	DSM - load management

EXHIBIT A

CUSTOMER CONTACTS

BUSINESS NAME	BUSINESS CONTACT	DATE	CONTACTED BY	COMMENTS
Santa Cruz County	Board of Supervisors	01/29/02	Ernesto Ojeda/Carl Dabelstein	
Sterilite	David Marshall	01/29/02	Tom Ferry & Bill DeJulio	LPS Transmission Rate
Partnership for Economic Development	Don Holbrook	01/29/02	Tom Ferry	
Mohave County	Ron Walker, County Manager	01/30/02	Tom Ferry	
Kingman Rotary Club	Club Program	02/06/02	Tom Ferry	
Chamber of Commerce Govt Affairs Committee	Committee	02/14/02	Ernesto Ojeda	
Kingman Lion's Club	Club Presentation	02/14/02	Tom Ferry	
General Cable	Peter Johanson	02/18/02	Paula Baxter	Disputing Sept. thru Oct. Billings
Havasu Kiwanis Club	Club Presentation	02/21/02	Tom Ferry	
Kingman Regional Medical Center (KRMCC)	Steve White	02/26/02	Tom Ferry & Paula Baxter	LPS 69kV
Kingman School District	Mike Ford	02/28/02	Tom Ferry	A/C Rebate Program
Sterilite	Dave Marshall	03/05/02	Bill DeJulio	LPS 69kV
Havasu School District	Joe Meli & Missy Wood	03/08/02	Tom Ferry	A/C Rebate Program
American Woodmark	Tom McLarty		Tom Ferry	Requested Future Audit - 928-692-4007

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**REJOINDER TESTIMONY
OF
LYLE D. MILLER

CONSULTANT FOR
CITIZENS COMMUNICATIONS COMPANY
ARIZONA ELECTRIC DIVISION**

DOCKET NO. E-01032C-00-0751

MARCH 19, 2002

1 Q. What is your name and business address?

2 A. My name is Lyle D. Miller. My business address is Morgan Stanley, 1585
3 Broadway, New York, NY 10036.
4

5 Q. Please provide your educational and professional background.

6 A. I am a Managing Director of Morgan Stanley, working in the firm's Global
7 Power and Energy Group, with a focus on strategic advisory work within the
8 U.S. and global power and utility industry. I joined Morgan Stanley in 1993
9 and have acted as team leader in a number of significant power and utility
10 M&A assignments, both cross-border and U.S. domestic in nature, including
11 mergers, acquisitions, asset divestitures, and restructurings. From August
12 1996 until May 1998, I was Head of Investment Banking for China
13 International Capital Corporation ("CICC"), a Beijing, PRC investment bank
14 formed as a joint-venture in 1995 by Morgan Stanley and four local and
15 regional investors. Prior to my work at CICC, I worked in Morgan Stanley's
16 Corporate Finance Department with a focus on infrastructure finance, power
17 and utility, and related assignments. In this capacity, I led teams in the
18 structuring and implementation of several structured financing and M&A
19 assignments within the electric power and other industries in the U.S., Latin
20 America and Asia. I graduated from Ball State University with a Bachelor of
21 Science degree in business in 1983, and received my Masters of Business
22 Administration from Washington University in 1989.
23

24 Q. Would you please summarize your testimony in this docket.

25 A. Morgan Stanley has been asked by Citizens Communications Company
26 ("Citizens") to provide additional testimony as to the potential adverse
27 financial implications on Citizens and its Arizona Electric Division ("AED") of
28 a disallowance of purchase power costs. In particular, I will address
29

1 various arguments made by Dr. Richard Rosen, Ms. Lee Smith, and Mr.
2 Douglas Smith in their respective surrebuttal testimonies. Morgan Stanley's
3 work with Citizens and regulated utilities similar to Citizens on both capital
4 markets and strategic assignments allow us to draw conclusions on the
5 detrimental effects of unforeseen and negative regulatory outcomes on the
6 financial health and long term stability of regulated utilities.
7

8 Q. Would a decision which disallows recovery of the costs incurred in
9 purchasing power to meet its obligation to serve affect Citizens' ability to
10 fund future operations?

11 A. From a capital markets macro perspective, utilities and corporations in
12 general are facing unprecedented difficulty in maintaining liquidity,
13 attracting new capital, and providing earnings transparency to investors.
14 Market turmoil triggered by investor concerns and skepticism over
15 accounting issues, earnings, and rating downgrades have created severe
16 liquidity and long term financing concerns. In the energy sector in
17 particular, concerns relating to volatile power and fuel prices, uncertain
18 regulatory situations, and the ability for utilities to transition to a
19 competitive market have placed scrutiny on the regulated utility group that
20 it has normally avoided due to its perceived lower level of risk and
21 regulated returns. Each new negative announcement, such as a harmful
22 regulatory decision, draws quick and potentially damaging reaction from the
23 financial community that can severely impact the ability of a utility to
24 finance itself on a going forward basis. In these times of "hyper-sensitive"
25 markets, the disallowance of prudently incurred costs by a regulatory
26 commission could very well shut down Citizens' and the AED's ability to
27 secure new capital, as well as replace existing obligations as they mature.
28 Creditors and potential equity investors would interpret the lack of rate
29

1 relief and inability to recover dollars spent wisely to ensure the needs of
2 customers during one of the most tumultuous energy crises in US history as
3 a broader indication that the Arizona Corporation Commission ("ACC") is
4 willing to jeopardize investor capital to avoid making potentially unpopular
5 decisions.

6
7 The ramifications of what effectively would become a significantly reduced
8 return on equity and impaired credit quality would make it nearly
9 impossible for AED to have access to capital in the public markets at
10 attractive rates and meet future obligations for capital expenditures for
11 growth and reliability requirements. These impacts of higher financing
12 costs and unexpected costs to raise future capital will eventually be borne
13 by customers either through increased rates or the difficulties of being
14 served by a financially distressed utility. A decision to disallow prudently
15 incurred costs – particularly of the magnitude suggested by Ms. Smith and
16 Dr. Rosen - would be very negatively viewed by the capital markets and
17 would likely inhibit future investment in Arizona utilities and harm the
18 overall ability of the AED to serve the public interest.

19
20 Q. How do the financial markets view Citizens' situation and performance
21 during the market turmoil of 2000 and why does the market's view matter
22 to the customers of the AED?

23 A. The financial markets expect Citizens to be able to recover costs that are
24 reasonably incurred. Citizens moved quickly to renegotiate its contract and
25 mitigate unforeseen increase in its purchase power expense. By not
26 allowing recovery of these costs, the ACC would indicate that during times
27 of severe duress for the regulated utilities in Arizona, investors and
28

1 shareholders are to bear the brunt of the expense to protect customers.
2 Investors will also expect a reasonable carrying cost on these charges as
3 they are waiting to be collected.
4

5 One principle that we believe all parties in this proceeding can agree on is
6 that a regulated utility like the AED attracts a different type of investor than
7 other energy companies and the market in general. The lower risk profile
8 and stable expected returns associated with a regulated utility like AED are
9 unique to its industry. The aversions to regulated institutions by some
10 investors who seek higher returns are appreciated by others who seek
11 financial stability and lower risk securities. Because of the perceived
12 stability of returns and cash flows associated with the AED's business, it is
13 able to attract capital even though its potential for growth and above
14 average returns is negligible. This being said, the AED cannot attract new
15 capital if a perceived negative regulatory environment has undermined the
16 security of returns for new investment. The AED will be placed in a position
17 where it does not have the organic characteristics to attract investors
18 looking for high returns and also where it cannot convince its traditional
19 sponsor base that their capital is being deployed in a secure and lower risk
20 company. This will leave the AED with few options and may lead to
21 financial instability or perhaps reliance on capital that is overpriced and
22 predatory.
23

24 Neither of these scenarios is good for the ratepayer in the long run.
25 Investors accept the public welfare obligations of utilities - like the purchase
26 of power and the obligation to serve - because they can rely on regulatory
27 bodies to ensure the recovery of prudently incurred costs, a fair return on
28 investment, and the return of principal. If the AED is not allowed to
29

1 recover costs associated with meeting its customer obligations during a
2 period of extreme duress, the market will assess the AED's situation as
3 bearing too much risk with no potential upside and funding will be
4 extremely difficult to find.

5
6 Q. Will the decision to disallow the prudently incurred purchase power costs of
7 the AED have any effect on other Arizona utilities?

8 A. The broader ramifications of an unjustified charge to investors by the ACC
9 may not only affect Citizens and the AED but could ultimately harm other
10 regulated utilities in Arizona as well. A public utility commission that is
11 perceived to be unfair by investors will raise the bar on attracting new and
12 lower cost capital for all of the regulated utilities in Arizona. It would also
13 potentially slow investment in Arizona infrastructure and energy markets by
14 outside parties who are wary of the liabilities of heavy-handed regulation.
15 One of the more worrisome arguments in Lee Smith's surrebuttal testimony
16 is that the AED should be treated differently than stand-alone companies in
17 Arizona. This "deep pockets" theory – that the AED can absorb a financial
18 hit because of its larger parent, Citizens – will not be well regarded by
19 potential investors in the Arizona energy market.

20
21 Q. Was Citizens or the AED imprudent in not correctly anticipating the western
22 power markets meltdown in the summer of 2000?

23 A. Douglas Smith, in his surrebuttal testimony, significantly oversimplifies the
24 situation that Citizens and the AED faced prior to the summer of 2000. As
25 a full service investment banking firm with practices that cover both the
26 utility and energy sector, Morgan Stanley is given unparalleled access to
27 savvy investors, energy traders, fixed income and equity analysts,
28 management of utility and energy companies, as well some of the most
29

1 respected consultants, lawyers, and academics that follow this sector.
2 During the time leading up to the California Energy Crisis, some of the most
3 sophisticated market participants, including large energy companies,
4 commodity traders, and wall street analysts, were caught by surprise as to
5 the magnitude of the situation. It would be extremely unreasonable to
6 expect that Citizens should have "outsmarted" the market.

7
8 Another grave oversimplification of Douglas Smith's surrebuttal testimony is
9 that Citizen's could have effectively mitigated the potential purchased
10 power liability by entering into some form of hedging transaction. The
11 argument that is set forth – that signs pointed to the types of fluctuations
12 actually experienced in the Western power markets – would certainly have
13 made hedging a significant amount of the AED's load prohibitively
14 expensive. That, taken with the fact that the hedges themselves carry
15 counter-party and financial risk, argues that significant hedging by the AED
16 would not have been prudent and/or feasible.

17
18 Q. What is the effect of regulatory risk on cost of capital and capital markets
19 access?

20 A. Regulatory risk, which can be best described in a financial market context
21 as the potential for an adverse regulatory decision to materially change the
22 financial condition of a company, is a significant factor in a company's
23 ability to secure financing. The investors that devote capital to the utility
24 industry are quite sophisticated in determining the amount of regulatory
25 risk associated with a company and price that into their investment.
26 Lenders understand the regulatory process, the proceedings a company
27 may face, and assess the overall posture and track-record of various
28 commissions. The disallowance of justifiably incurred expenses like the

1 AED's will negatively affect investors' perception of the AED, not only for
2 the financial effect that the denial of the recovery of power costs will have
3 but for the creation of significant risk in the future. Investors have many
4 opportunities to put capital to work and will avoid a volatile regulatory
5 situation whenever possible. The AED may be forced to look for new forms
6 of capital and rely on a much different market potential, significantly
7 increasing its financing costs.
8

9 Q. Will the Staff and RUCO proposals to require the AED to pursue a FERC
10 complaint against its power supplier have any adverse effect on the AED's
11 ability to attract capital?

12 A. One option that the Staff's and RUCO's witnesses are asking the ACC to
13 consider is to disallow a substantial portion of the AED's power costs while
14 the AED pursues a claim at the FERC. This potential time lag, up to three
15 years, may be as detrimental to the AED as disallowing the costs
16 altogether. Investors dislike uncertainty and will penalize the AED for not
17 only the potential for the complete disallowance of these costs but will price
18 in the ambiguity associated with an ACC decision after any FERC decision.
19

20 Q. Please describe the pro forma effects on the AED's ability to raise low cost
21 capital of an adverse regulatory decision.

22 A. In Dr. Avera's rebuttal testimony, he describes the pro forma financial
23 impact of Ms. Smith's recommendation. Ms. Smith's recommendation,
24 which would effectively reduce the pre-tax interest coverage ratio at the
25 AED, viewed on a stand alone basis, to 1.25x would shut down the AED's
26 access to the investment grade markets and severely limit any financial
27 flexibility that the AED and its customers now enjoy. Given the overall
28 credit market and the rating agencies' focus on liquidity, this significant
29

1 change in coverage ratios will disenfranchise current investors and limit the
2 available funds for the AED in the future. The effect on financing costs of
3 dropping from a middle investment-grade rated company to a lower
4 speculative company will be enormous. Beyond the additional borrowing
5 costs, which could be hundreds of basis points depending on the market
6 reaction, the magnitude of the change and longer term effect will cause
7 investors to avoid the financial instability associated with the AED. The AED
8 will be forced to look to new markets for capital, markets that are more
9 expensive and have a much smaller amount of available funds for the AED.
10 The "junk" market also is extremely volatile and may not be available to
11 access as often as the AED's traditional source of financing.
12

13 Q. Is there any evidence that the California Public Utility Commission's
14 reluctance to protect investors or utilities in the summer of 2000 detracted
15 from financial flexibility?

16 A. As the financial markets began to awaken to the magnitude of the deferrals
17 being created in California in the summer of 2000, they reacted quickly.
18 The cost to borrow rose significantly, the utilities were not able to raise
19 additional equity, and the credit issues became so large that most lenders,
20 including bank capital, began to reduce their exposure. The indecisiveness
21 of the regulatory commission, coupled with the issues becoming political,
22 produced the type of overhang that investors have trouble evaluating. The
23 result of the confusion was a market where California utilities and others in
24 the west were not able access all of the options available because the
25 regulatory quagmire limited potential choices.
26

27 Q. Does this conclude your testimony?

28 A. Yes, it does.
29