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BEFORE THE ARIZONA CORPORATION COMMISSION RECEIVED

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3 WILLIAM A. MUNDELL  
Chairman  
4 JIM IRVIN  
Commissioner  
5 MARC SPITZER  
Commissioner  
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AZ CORP COMMISSION  
DOCKET CONTROL

8 IN THE MATTER OF THE APPLICATION OF  
9 THE ARIZONA ELECTRIC DIVISION OF  
10 CITIZENS COMMUNICATIONS COMPANY  
11 TO CHANGE THE CURRENT PURCHASED  
12 POWER AND FUEL ADJUSTMENT CLAUSE  
13 RATE, TO ESTABLISH A NEW PURCHASED  
14 POWER AND FUEL ADJUSTMENT CLAUSE  
15 BANK, AND TO REQUEST APPROVE  
16 GUIDELINES FOR THE RECOVERY OF COSTS  
17 INCURRED IN CONNECTION WITH ENERGY  
18 RISK MANAGEMENT INITIATIVES.

Docket No. E-01032C-00-0751

**STAFF'S NOTICE OF FILING  
SURREBUTTAL TESTIMONY**

16 In accordance with the January 11, 2002 Procedural Order, the Staff hereby files the  
17 surrebuttal testimony and exhibits of Lee Smith and Douglas C. Smith.

18 DATED this 13th day of March, 2002.

ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission

DOCKETED

MAR 13 2002

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ORIGINAL

**BEFORE THE ARIZONA CORPORATION COMMISSION**

WILLIAM A. MUNDELL

Chairman

JIM IRVIN

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MARC SPITZER

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IN THE MATTER OF THE APPLICATION OF  
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DOCKET NO. E-01032C-00-0751

SURREBUTTAL TESTIMONY

OF

LEE SMITH

ON BEHALF OF

ARIZONA CORPORATION COMMISSION STAFF

March 13, 2002

1    **I.       INTRODUCTION**

2

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

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

6

7    **Q.       Did you file direct testimony in this Docket?**

8    A.       Yes. I filed direct testimony on February 8, 2002.

9

10   **Q.       What is the purpose of your rebuttal testimony in this docket?**

11   A.       My testimony rebuts arguments made in the rebuttal testimonies of Mr. Breen,  
12            Mr. Dabelstein, Mr. Flynn, and Mr. Avera. In addition, I will discuss updating  
13            the financial recommendations in my original testimony.

14

15   **II.       SUMMARY**

16

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

18   A.       I found that there were significant problems in the Old Contract that could result  
19            in Citizens' power costs rising if market prices increased. Testimony by me and  
20            Mr. Smith explained that Citizens should have known that market prices could  
21            rise significantly in the summer of 2000. However, I found that Citizens did not  
22            take appropriate steps to address these matters. In addition, although Citizens  
23            testified that it believed it had been overbilled under the Old Contract, it has not  
24            pursued two potential overbilling issues to the fullest. I recommended that  
25            Citizens not be allowed to collect the amount of dollars that could be disputed  
26            until it has made every effort to obtain relief from FERC or the courts, and that it  
27            not be allowed a carrying charge on this amount.

28

29

30

1 **Q. What do Citizens' rebuttal testimonies say in response to these points?**

2 A. Citizens agrees that there were problems in the Old Contract, but argues that its  
3 response was appropriate and adequate. Rebuttal testimony indicates that its  
4 advisors were not optimistic about its overbilling claims. This testimony also  
5 indicates that it did not pursue these claims primarily because doing so would  
6 "have jeopardized negotiations". Citizens has not provided any reason why it is  
7 not currently pursuing these claims, but instead is asking ratepayers to cover this  
8 potential overbilling.

9  
10 **Q. Does Citizens raise any new issues?**

11 A. Citizens now claims that it worked hard to negotiate a new contract from the time  
12 it learned of APS' interpretation of the System Incremental Costs (SIC) as  
13 including reliability purchases. Citizens also claims that it could not have  
14 anticipated that it would ever be charged market prices for Schedule A. This is  
15 significant because this is a large portion of their total bill.

16  
17 **Q. Have Citizens' rebuttal testimonies caused you to modify any of your  
18 positions?**

19 A. No, they have not.

20  
21 **III. MANAGEMENT OF THE CONTRACT**

22  
23 **Q. You have testified that Citizens knew that APS believed it could charge  
24 market prices to Citizens, although Citizens did not interpret the contract in  
25 this manner, and that Citizens did not effectively address this problem. How  
26 do Citizens' rebuttal testimonies portray this issue regarding management of  
27 the Old Contract?**

28 A. Citizens admits that it was aware it could be charged market prices for some of its  
29 load because of the ambiguities in the Old Contract. The only actions it took to  
30 attempt to address its problems prior to the end of 2000 were to negotiate  
31 regarding the interpretation of the ambiguous terms in the contract with APS,

1 which failed to achieve any positive result, to attempt to negotiate a new contract,  
2 and finally to begin to establish programs to manage its load.

3  
4 Citizens' characterization of what it did from late 1999 through the summer of  
5 2000 is consistent with my testimony. It devoted all its efforts to renegotiating  
6 with APS. According to the evidence provided, negotiations consisted, first, of  
7 arguing the definition of SIC in the Old Contract, and second, of attempting to  
8 negotiate a modified contract. There is no evidence that Citizens performed any  
9 evaluation of the wholesale market before the summer of 2000, even though it  
10 knew it could be subject to market-based pricing. There is no evidence that  
11 Citizens had outside counsel and/or consultants to advise it on the SIC  
12 interpretation issues or a revision of the Old Contract, or the negotiations.

13  
14 **Q. Mr. Breen's rebuttal testimony states that prior to the summer of 2000,**  
15 **"Citizens fully recognized the import of the disagreement in interpretation of**  
16 **SIC language." (Rebuttal p.24) Does the evidence in this case support this**  
17 **statement?**

18 **A.** Absolutely not. We have repeatedly asked the Company for the basis of its  
19 decisions regarding pursuit of the SIC issue, and the Company has not  
20 demonstrated that it engaged appropriate assistance or considered all potential  
21 options. The Company has indicated that prior to the summer of 2000, it never  
22 even prepared any estimates of the impact of SIC pricing, even though it knew  
23 that SICs might be crucial to its power bills. (Data Response to Staff 5-19,  
24 contained in Attachment S-2 of my original testimony) Moreover, it was  
25 proceeding as if certain that it would not be charged market prices for Schedule  
26 A, while that had not been established as fact, and which turned out to be wrong.  
27 This will be discussed further under Section VI.

1 **Q. Have Citizens' rebuttal testimonies demonstrated that it made every effort to**  
2 **resolve the interpretation of the SIC issue?**

3 A. No. The "debate" over this issue continued from when Citizens first was rebilled  
4 in the summer of 1999 until the MOU of May 18, 2000, without resolution.  
5 Citizens did not take the issue to either FERC or the courts, leaving it in the  
6 position of continuing to pay bills based on what it believed to be an incorrect  
7 interpretation.

8

9 **Q. Has Citizens now provided more explanation as to why Citizens did not**  
10 **pursue this issue?**

11 A. Mr. Flynn's testimony states that if Citizens lost the " 'economic' ... issue, it  
12 would lose its main line of defense against the high costs of power purchased..."  
13 (Rebuttal p.11). Mr. Flynn further indicates his opinion that "Litigation ....would  
14 not have provided any near-term relief and undoubtedly would have forced a  
15 deferral of any serious negotiating efforts" (Rebuttal p.18).

16

17 **Q. Do you agree with Mr. Flynn?**

18 A. Not in this matter. I do not find that 'losing its line of defense' is a convincing  
19 argument. Since Citizens was being billed according to the highest interpretation  
20 of the contract, and had been for power purchased from 1998, I do not see how  
21 affirmation of that billing policy would have left it worse off. There is no  
22 evidence that the SIC interpretation issue was even "on the table" for negotiation  
23 between APS and Citizens after the summer of 2000. Citizens did not have any  
24 defense without appealing to FERC or the Courts.

25

26 With regard to the effect on the negotiation of a new contract, as long as APS did  
27 not think its interpretation of the contract terms was being challenged, this  
28 interpretation would be what it would use as a basis of comparison to a new  
29 contract. In other words, if APS' interpretation was not challenged, APS would  
30 receive more revenue from the Old Contract. The more modifications to the  
31 contract reduced those revenues, the less attractive the modifications would be to

1 APS. If the interpretation was threatened, APS would have to consider the  
2 possibility that its revenues under the Old Contract might be less. If Citizens had  
3 petitioned FERC or the courts, that petition would seem to me to have been a  
4 bargaining chip. The experience of the summer before did not indicate that being  
5 the "good guys" provided any advantage at all to Citizens.  
6

7 **Q. Does Mr. Flynn's advice explain why Citizens did not act to resolve the SIC**  
8 **question prior to the summer of 2000, as you have recommended it should**  
9 **have?**

10 A. No, it does not, because this advice was not provided until 2001. There is no  
11 evidence that the Company itself had significant doubts as to the efficacy of its  
12 argument prior to receiving this advice. In spite of its evident certainty that it was  
13 being overbilled, Citizens did not achieve the leverage through this issue that it  
14 could have, had it retained expert advice, such as it did in December 2000. The  
15 Company was being billed according to APS' interpretation, and there was no  
16 indication that this would change without more action on Citizens' part, such as  
17 engaging assistance and or actually filing a complaint with FERC or the court. As  
18 I indicated earlier, knowledge regarding its exposure could have been useful to  
19 Citizens. Lack of knowledge has had only a negative impact.  
20

21 **Q. Did Citizens attempt to renegotiate the contract as soon as it became aware**  
22 **of the interpretation problem?**

23 A. This is not clear. Mr. Breen's rebuttal testimony indicates that the Company was  
24 attempting to change the contract from late 1999. However, this was not evident  
25 from data responses provided previously. For instance, in response to Staff Data  
26 Request 7.05 (contained in Attachment S-3 to my testimony) regarding  
27 negotiations in the spring of 2000, discussions of alternative power supply  
28 arrangements are dated from April 27, 2000. This evidence indicates that earlier  
29 "negotiations" were primarily, if not entirely, disputes about the SIC definition.  
30

1 Mr. Breen's rebuttal testimony objects to my characterization of Citizens' efforts  
2 to renegotiate as "very modest" (Rebuttal p.20) According to Mr. Breen there  
3 were "intense negotiations" between the companies, involving senior  
4 management. Mr. Breen's definition of "intense" may involve many phone calls  
5 or meetings, but I have not seen evidence that during the period prior to the  
6 summer of 2000 Citizens enlisted outside counsel or consultants who could have  
7 provided the kind of advice that was solicited in December of 2000 from the law  
8 firm of Wright & Talisman. I also note that the first written document fully  
9 expressing Citizens' opinion on the SIC issue appears to be the letter from Mr.  
10 Breen on March 7, 2001 (Staff Data Response 4.1, contained in Attachment S-3).  
11 This would suggest that the earlier "negotiations" did not involve a written  
12 statement of Citizens' position. This again does not appear to be a very effective  
13 form of negotiating. There is little evidence in this case regarding the efforts  
14 made by Citizens other than Mr. Breen's testimony.

15  
16 **Q. Does Mr. Avera also comment on the negotiations?**

17 A. Yes. Mr. Avera says that Staff believed that "...if somehow the AED had  
18 negotiated harder APS would have changed its position." (Rebuttal p.19), which  
19 he finds an unrealistic position.

20  
21 **Q. Did Mr. Avera correctly describe Staff's position? Did Staff expect that if  
22 Citizens had negotiated harder the results would have been different?**

23 A. This is not an accurate description of Staff's position. The issue is more a matter  
24 of whether Citizens conducted effective negotiations and when it did so. Outside  
25 counsel and advisors would have provided a more effective team, that would have  
26 provided more leverage in negotiations, but they were not retained until well after  
27 the summer of 2000. It also appears that a serious effort to really renegotiate the  
28 contract, as opposed to just arguing about the SIC definition, did not begin until  
29 late April of 2000. Citizens gave up its right to challenge APS' Market Pricing  
30 Filing at FERC in return for an MOU that did not solve its problem; and Citizens  
31 evidently did so without advice of expert counsel.

1  
2 Staff agrees that if Citizens' negotiations had resulted in a lasting commitment to  
3 eliminate minimum pricing, rather than an MOU that evidently had no force, the  
4 Company would have been better off. There would have been a greater  
5 possibility of achieving this result if these negotiations had begun earlier with an  
6 appropriate team backing up Citizens. As it was, although Mr. Breen testified that  
7 when the MOU was signed "both parties were keenly interested in achieving the  
8 objectives outlined in the MOU" (Rebuttal p. 22), the actual results were that  
9 APS got what it wanted, which was Citizens' nonobjection to APS' Market Power  
10 Filing, and Citizens got nothing except the \$1.5 million. This was a payment in  
11 Settlement over a previous overbilling dispute over \$4.5 million. These are not  
12 results one would expect from an effective negotiation effort. At a minimum,  
13 Citizens should not have given up anything without a guarantee of some change  
14 in the contract.  
15

16 **IV. THE HEDGING ISSUE**

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

19 A. I criticized the Company for not having taken any actions that might have served  
20 to "hedge" its power costs, including pursuit of either a physical hedge or a  
21 financial hedge, or planning to run Valencia during high-cost periods.  
22

23 **Q. One specific action that you recommend the Company should have**  
24 **considered was a hedge, whereby the Company or APS would purchase a**  
25 **block of power at a fixed price as insurance against price increases. Does the**  
26 **Company agree that it could have taken such an action?**

27 A. The Company has not denied that it could have sought a hedge. However, Mr.  
28 Dabelstein provides various reasons why it did not do so, and Mr. Avera offers  
29 opinions as to why it should not have done so.  
30

1 **Q. According to Mr. Dabelstein, what were the reasons that Citizens did not**  
2 **seek a hedge?**

3 A. Mr. Dabelstein argues that Citizens should not have undertaken a financial hedge,  
4 because "there must be some reasonable expectation of significant potential for  
5 volatility and spikes in price" (Rebuttal p. 3), and the Company had no such  
6 expectation. His second reason was that the Company did not know what the  
7 regulatory treatment of such a hedge would have been. His rebuttal testimony  
8 states "Before a utility embarks on a non-traditional course of action that will  
9 result in the incurrence of new types of costs," regulatory treatment must be  
10 known and considered, or such action would be a breach of its responsibility to  
11 investors. (Rebuttal p. 7)

12

13 **Q. Are any of these arguments convincing?**

14 A. No. First, I believe there were good reasons to be concerned that market prices  
15 could increase substantially. The price expectation issue will be addressed in  
16 rebuttal testimony by Mr. Smith. Second, Mr. Dabelstein's argument on  
17 regulatory treatment seems to me to consider only stockholders, and not  
18 ratepayers. This would suggest that even if the Company was certain that an  
19 action would reduce costs below what they would otherwise be, that action would  
20 not be taken unless the Company had an advance guarantee of its regulatory  
21 treatment. The Company has an obligation to ratepayers as well as an obligation  
22 to stockholders. For this reason, it should have at least considered a hedge, and if  
23 such consideration indicated a likelihood of benefits to ratepayers, at the least it  
24 should have made a presentation regarding the issue to the Commission, if  
25 Citizens believed it was necessary to do so.

26

27 **Q. What are Mr. Avera's opinions regarding a hedge?**

28 A. Mr. Avera argues that requesting a hedge would have jeopardized negotiations.  
29 Mr. Avera also interprets my testimony as saying that it was clear to market  
30 participants that higher prices were coming, and therefore a hedge would have  
31 been very expensive. He expresses this rather colorfully as "Ms. Smith's

1           suppositions regarding expectations for higher wholesale power prices and the  
2           AED's ability to hedge are essentially analogous to suggesting that purchasing  
3           homeowners insurance after your house is on fire would be an economically  
4           feasible transaction." (Rebuttal p. 24)

5  
6           **Q.    Please respond to Mr. Avera's comments.**

7           **A.**    First, Mr. Avera is concerned that requesting a hedge would have jeopardized  
8           negotiations with APS. It is unclear to which negotiations he is referring. If he  
9           was referring to the debate over the interpretation of the SIC, a request for a hedge  
10          could have been perceived as an indication that Citizens was not certain it could  
11          win this battle. There is some possibility that this might have hardened APS'  
12          position. This seems to be rather a small possibility, however, since APS had  
13          been maintaining its position from the summer of 1999. Given the potential large  
14          cost of losing this issue, I believe that Citizens certainly should have considered  
15          requesting a hedge in spite of the small possibility that this would affect APS'  
16          position. Moreover, as Mr. Smith notes in his rebuttal, a financial hedge with  
17          another party could also have been considered, and APS would not necessarily  
18          have to be aware of such an instrument.

19  
20          If the negotiations being referred to as possibly threatened are those regarding a  
21          change in the contract, such as what Citizens believed it had negotiated in the  
22          MOU, a separate agreement regarding a summer hedge purchase should not have  
23          endangered the negotiation, but would have provided insurance in case that  
24          negotiation was not successful. With regard to Mr. Avera's second argument, that  
25          everyone knew high prices were coming, he has misunderstood my testimony. I  
26          have testified that a reasonable analysis of the power market would have raised  
27          the real possibility that prices in the summer of 2000 might be much higher than  
28          they had been. Mr. Smith's rebuttal testimony will address this issue in detail.

29  
30          **Q.    In response to your testimony that Citizens should have been aware that**  
31          **prices might increase significantly, does Citizens attempt to provide any**

1           **other evidence as to why it should not have been aware that prices might**  
2           **increase?**

3       A.     Yes. Mr. Smith responds to testimony by Mr. Avera on this topic. Aside from  
4           these arguments, Citizens argues that it should not have known that prices would  
5           increase, because “Ms. Smith and her firm did not anticipate the market prices  
6           that actually occurred in 2000” (Rebuttal p. 27) when she advised Staff on various  
7           settlements. The implication is that Staff and La Capra Associates had endorsed  
8           the view that prices would definitely remain stable. This does not accurately  
9           describe the position taken by Staff in the stranded cost/rate unbundling  
10          settlements. First, Mr. Breen’s presumption that La Capra Associates had  
11          reviewed and approved of Citizens’ market price forecast is simply not correct.  
12          La Capra did not work for Staff in the initial testimonies and hearings on stranded  
13          cost that addressed market price forecasts. We had no opportunity to weigh in  
14          regarding the market price projections put forth in those proceedings. We were  
15          engaged in the development of unbundled rates and transition charges. Because  
16          (i) we had not participated in the original market price projections; (ii) those  
17          projections varied between utilities; and (iii) those projections were becoming  
18          outdated, we attempted to devise settlements that were not dependent on  
19          projections of market prices.

20  
21          Interestingly, Citizens does not refer to the two cases where this was most clearly  
22          evidenced. In the TEP Settlement, stranded cost collection was directly  
23          dependent on market prices. In the APS case, the initial Settlement of November  
24          1998 (that was rejected by the Court) was designed on the same basis. Ms. Smith  
25          supported a credit that was based on using the Palo Verde futures contract prices,  
26          increased by an adder to reflect ancillary services and other costs of providing  
27          power. Stranded cost collection would thus be determined by actual market  
28          prices. Regarding the subsequent Settlement, to which Staff was not a party, I  
29          testified that the credit offered by APS was not adequate to allow competition at  
30          that time. These credits were 3.0 cents/kWh, for the Extra-Large General class,  
31          4.1 cents/kWh for the General Service class, and 4.5 cents/kWh for the

1 Residential Class. I did not make any projections for the year 2000 or beyond,  
2 although I did indicate in testimony that I expected market prices to increase over  
3 time.

4  
5 In the cases that Mr. Breen and Mr. Dabelstein address, the initial "market price"  
6 used for stranded cost computation did not reflect Staff's view of market prices.  
7 In the AEPCo case, the first year formula for computation of stranded cost  
8 compared AEPCo's lost revenues to the value of 3.0 cents/kWh. Mr. Dabelstein  
9 characterizes this as "testifying in support of a market price estimate" (Rebuttal  
10 p.4). There was no testimony regarding market price. A value was necessary as a  
11 placeholder in the first year in which there was no other data. In subsequent  
12 years, the value used to calculate stranded cost would be the actual price that  
13 AEPCO received for power freed up by customers choosing alternative suppliers.

14  
15 Mr. Dabelstein also claims as evidence that Staff had no expectation that market  
16 prices would spike during the summer of 2000, the Citizens Settlement. Staff  
17 supported a provision regarding the CTC (stranded cost) balance that allows faster  
18 recovery of stranded cost if the balance exceeds \$3 million (Rebuttal p. 4). This  
19 also is not evidence of any expectation about the stability of market prices. A  
20 sizable increase in the CTC balance would require a large amount of load to  
21 choose an alternative supplier. The relationship between the customers choosing  
22 alternative suppliers and market price changes would be more likely to be inverse  
23 than direct. If market prices rose rapidly, alternative suppliers would increase  
24 prices, making Citizens service more attractive relative to alternative suppliers  
25 than if market prices were low. Also relevant is that the Citizens CTC was  
26 designed to "provide for recovery of the difference between generation revenues  
27 that would have been paid by departing customers and the costs that will be  
28 avoided as load departs." A market price estimate for the future is not necessary  
29 in this formulation.

1 **V. THE VALENCIA ISSUE**

2

3 **Q. Does Citizens provide evidence as to why it did not make any investments in**  
4 **Valencia prior to the summer of 2000?**

5 A. Mr. Breen's rebuttal testimony indicates that Citizens did not take actions to run  
6 Valencia for economics because it didn't anticipate the price increase, and its  
7 running costs were almost "double the highest month of forward prices."  
8 (Rebuttal p.30) Mr. Smith addresses this explanation in his rebuttal testimony.

9

10 **Q. Does Citizens claim that it could not have ever run Valencia for economics**  
11 **without some investment?**

12 A. No. Citizens does not say that is was not possible to operate the units for  
13 additional hours when not needed for reliability purposes. It provides some  
14 further information about its investments, presumably those included previously  
15 under the description as "overhaul" and parts replacement. Mr. Breen now  
16 describes those investments as including running performance tests, replacing  
17 breakers, updating the control system and overhauling key components. If  
18 Valencia could have been run during the highest priced hours with little or no  
19 investment, by simply monitoring the market and instructing the operator to be  
20 available, this would have been very cheap insurance.

21

22 **VI. NEW INFORMATION ABOUT CITIZENS' VIEW OF ITS CONTRACT**  
23 **AND OF THE MOU**

24

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

28 A. Yes. Mr. Breen's new characterization of its high summer bills in 2000 was that  
29 they were "...a result of APS' reversal of its prior commitments in negotiations  
30 and its aggressive interpretation of SSA." (p. 24). However, Mr. Breen believes  
31 that Citizens couldn't have reasonably anticipated this.

- 1   **Q.    How could this behavior have been anticipated?**
- 2    A.    If Citizens had asked itself, what might APS do if prices increase rapidly, it seems  
3       likely that it would have expected APS to protect its own interests before those of  
4       Citizens.  Although Mr. Breen objects to my characterization of the desired  
5       change as a “verbal commitment”, arguing that Citizens “had secured reasonable  
6       assurance from APS that it would follow through on its word...” (Rebuttal p. 22),  
7       the fact that APS did not eliminate the minimum billing provision is clear  
8       evidence that depending on a utility’s “word” when so much was at stake was not  
9       good strategy.  Mr. Breen further believes that there was “...no way for Citizens  
10      to foresee that APS would take these actions.”  However he then goes on to  
11     explain that this was because APS’ actions were motivated by high prices that  
12     actually occurred (Rebuttal p. 22).
- 13
- 14   **Q.    Do you agree with Mr. Breen that Citizens could not have foreseen that APS’**  
15       **would fail to turn the MOU into a contract that agreed with Citizens’**  
16       **understanding of the MOU?**
- 17    A.    No.  According to Mr. Breen, APS’ action was a natural result of high prices.  If  
18       Citizens had considered the possibility that there might be high market prices, it  
19       should have expected, according to Mr. Breen’s reasoning, that APS would  
20       behave in this manner.
- 21
- 22   **Q.    What does Mr. Breen say about Schedule A?**
- 23    A.    Mr. Breen’s rebuttal states that he believed that Schedule A, which would not  
24       have been modified by the terms in the MOU, would not have been priced on the  
25       SIC/minimum bill in the summer for three reasons: (1) because the calculation of  
26       Schedule A rates in the original application was on a nominal basis; (2) because  
27       they had previously negotiated a reduction in Schedule A related to the argument  
28       that embedded costs were lower than nominal prices; and (3) because no bill prior  
29       to summer of 2000 had even shown calculation of “Minimum Charges”.
- 30

1 **Q. Should Citizens have relied on these three facts as a guarantee that Schedule**  
2 **A might not be priced on the basis of the SIC/minimum bill computation?**

3 A. In hindsight, it is clear that they were not a guarantee, since APS did begin  
4 charging Schedule A on this basis in August of 2000. However, even before the  
5 fact, these should not have been taken as providing any assurance of how  
6 Schedule A bills would be calculated in a high price market situation. The  
7 contract provided APS with the ability to charge on this basis. According to Mr.  
8 Flynn, the "unavoidable problem...was the language of Schedule A and the rate  
9 exhibit, which set forth minimum and maximum bounds for the stipulated rates,  
10 included SIC in the minimum charge..." In other words, the same language that  
11 led to the minimum bill computations for Schedules B and C was also contained  
12 in Schedule A. There were reasons why Schedule A bills might not have shown  
13 the minimum bill computation previously. Possibly market prices had not been  
14 high enough to make the minimum bill relevant for Schedule A previously.

15  
16 **Q. Could Citizens have investigated this issue earlier?**

17 A. Certainly. It appears that Mr. Flynn's advice on the subject was not requested or  
18 provided until December 2000. Citizens does not indicate that it either  
19 investigated this possibility that Schedule A had not been charged the minimum  
20 bill previously or that Citizens asked APS about whether Schedule A could be  
21 subject to the minimum billing provisions.

22  
23 **VII. WHY THE COMPANY DID NOT PURSUE THE SIC AND OTHER**  
24 **CONTRACT BILLING ISSUES SUBSEQUENT TO THE SUMMER OF**  
25 **2000**

26  
27 **Q. Your testimony criticizes Citizens for not fully pursuing resolution of billing**  
28 **disputes based on two different disputes, and recommends that the Company**  
29 **not be allowed to collect an amount that it claims is in excess of its**  
30 **interpretation of what the contract allows it to be billed, until the Company**

1 **has fully pursued these issues. Has Citizens provided additional information**  
2 **about why it did not pursue the SIC billing issues?**

3 A. With regard to billing disputes with APS, Citizens now has provided testimony by  
4 Mr. Paul Flynn regarding advice provided by his law firm. Mr. Flynn's firm was  
5 engaged in December 2000 to assist with the dispute concerning the Old Contract.  
6 Mr. Flynn opines that Citizens was prudent in negotiating new power supply to  
7 eliminate risk, "...rather than pursuing litigation that could provide no immediate  
8 relief from high costs, would take years to resolve, and ultimately was not likely  
9 to provide relief". (Rebuttal p. 5)

10  
11 **Q. Did Mr. Flynn refer to any advice provided to Citizens prior to January**  
12 **2001?**

13 A. No, he did not.

14  
15 **Q. Did Mr. Flynn's testimony indicate any opinion about the prudence of**  
16 **challenging APS' billing practices under the Old Contract, now that a New**  
17 **Contract has been signed and is in operation?**

18 A. No, it did not.

19  
20 **VIII. UPDATING PPFAC INFORMATION AND OTHER ISSUES**

21  
22 **Q. In your original testimony, you recommended that Citizens be required to**  
23 **defer collection of \$49 million, representing the amount that Citizens**  
24 **believed it had been overbilled. You also suggested that the other issue on**  
25 **which it had an overbilling claim, related to the treatment of purchased**  
26 **power, would have been worth about \$20 million for the summer of 2000.**  
27 **Should these amounts be updated?**

28 A. Yes, they should be updated. Mr. Rosen's testimony cites \$70 million for the  
29 amount that Citizens believed had been overcollected through May of 2001  
30 (Rosen Testimony p. 6) Once Citizens' total unrecovered bills are computed, the  
31 total disputed amount of \$70 million should be deferred for collection until this

1 issue has been pursued. For instance, if the Commission issues an order that  
2 allows a change in the PPFAC on May 1, the relevant total undercollection would  
3 be the end of April 2002. This number is not yet on the record. Citizens provided  
4 an estimate of the PPFAC balance for the end of April, in Revised Exhibit No. 3,  
5 but this estimate assumed that Citizens received an increase in its PPFAC at the  
6 beginning of January. Since the PPFAC has not been changed, the actual  
7 undercollections at the end of April will be higher than that shown in this exhibit.  
8

9 I have made a rough estimate that the total PPFAC balance will be about \$105  
10 million by the end of April. This would revise the amount that I would  
11 recommend for collection. The denial of \$7 million would leave \$98 million  
12 (based on the total assumed above), and the deferral of the \$70 million in disputed  
13 billings would leave \$28 million to go immediately into a PPFAC. Since this  
14 amount is much smaller than the number I had referred to based on the  
15 Company's original filing values, I would also recommend that the Company be  
16 allowed to collect these dollars over three or four years rather than six. The  
17 concept that I support is that the larger the amount allowed by the Commission,  
18 the longer should be the time for collection.  
19

20 **Q. Is there anything else regarding the PPFAC bank that you would like to**  
21 **update?**

22 **A.** Yes. According to the responses to Staff Data Responses 10.1 and 10.3  
23 (contained in Attachment S-3), under the New Contract, if the Valencia units are  
24 run by APS for economics, Citizens would incur the fuel and operating and  
25 maintenance costs associated with this operation, and these costs would appear as  
26 costs charged to the PPFAC bank. This could result in Citizens customers being  
27 billed \$.13 per kwh for energy not used by Citizens. Another way of looking at  
28 this would be that Citizens would be paying APS \$.058 for all of their load plus  
29 \$.13 for the kwhs that Valencia generated for APS. While I was not involved in  
30 the original development of the PPFAC clause, I expect that Valencia costs were  
31 included in the clause because they were expected to benefit Citizens ratepayers.

1 Before the New Contract, if the unit were run for economics the energy generated  
2 would replace more expensive energy that otherwise would have been provided  
3 by APS.  
4

5 **Q. How has this treatment of Valencia costs been reflected in this case?**

6 A. It has not been reflected in Citizens presentation or estimate of the future PPFAC  
7 that it will need. Revised Exhibit 3, which purports to represent future PPFAC  
8 costs, only includes Valencia costs that would result from expected reliability  
9 operation of the units. However, it appears that additional costs associated with  
10 economic operation of the units by APS under the New Contract could be  
11 included in the PPFAC balance and under Citizens requested treatment would  
12 serve to increase the undercollected amount.  
13

14 **Q. How do you recommend the Commission address this issue?**

15 A. I have recommended that the New Contract should be addressed in the  
16 Company's next rate case. It also might be desirable to address the PPFAC  
17 question more generically, even before the next rate case. The appropriateness of  
18 this treatment of Valencia costs not associated with reliability should be addressed  
19 either in a rate case or in a proceeding on the PPFAC.  
20

21 **Q. Are there other issues with the New Contract that the Commission may need  
22 to address?**

23 A. Yes. The Commission should consider Citizens' compliance with Arizona  
24 Administrative Code R14-2-1606.B. The New Contract appears to be  
25 inconsistent with the requirement that distribution companies buy power from the  
26 market.  
27  
28  
29  
30  
31

1 **IX. IMPACT OF DENIAL AND DEFERRAL OF RECOVERY**

2  
3 **Q. What is the Company's position with regards to your recommendations**  
4 **regarding recovery: that is, a denial of \$7 million, a deferral of the disputed**  
5 **amount, and recovery over six years without carrying charges?**

6 A. Mr. Dabelstein argues that the denial of carrying costs on the recoverable balance  
7 is conceptually inconsistent with the accrual of carrying charges that was  
8 supported by Ms. Smith in regard to the stranded cost settlement.

9  
10 **Q. Do you find that the disallowance of carrying costs in this case is inconsistent**  
11 **with the stranded cost settlement?**

12 A. No. The stranded cost settlement addressed power costs that the Company  
13 incurred but could not collect immediately. However, this potential shortfall in  
14 power costs would have been caused by customers choosing alternative suppliers,  
15 raising the Company's average power costs. The Company would have had no  
16 responsibility for customer choice. In this case, my testimony has demonstrated  
17 that the Company has borne some responsibility for the situation that it is in.

18  
19 **Q. Does Mr. Dabelstein present other arguments against your proposal recovery**  
20 **scheme?**

21 A. Yes. Mr. Dabelstein argues that my recommendation against carrying charges  
22 "defies economic logic, and sound ratemaking principles," since utilities' rates of  
23 return reflect a perceived low business risk.

24  
25 **Q. Please comment on this.**

26 A. I understand that Citizens' allowed rate of return does reflect a prior Commission  
27 judgment about risk, as well as a number of other factors. However, it is also  
28 normal ratemaking policy to reduce utilities' rates of return below that  
29 recommended on straight financial considerations when regulators find  
30 management performance deficient.

1 **Q. Does Mr. Avera also comment on the financial implications of your**  
2 **recommendations?**

3 A. Yes. He makes the same argument that Mr. Dabelstein does regarding the  
4 relationship between the rate of return and risk. He also argues that to deny a  
5 return on \$80 million of underrecovered power costs would reduce the rate of  
6 return for Citizens to 4.73%, below a return on long-term Treasury bonds, "which  
7 is widely considered to be a risk-free rate." (Rebuttal p.39) He argues that this  
8 would result in reducing Citizens' coverage ratio to a level that would not  
9 maintain Citizens' financial integrity or allow it to attract capital on reasonable  
10 terms. Mr. Avera also argues that "there is no justifiable reason to deny the AED  
11 carrying charges on reasonable and necessary expenses..." (Rebuttal p.41)  
12

13 **Q. Please respond to Mr. Avera's comments.**

14 A. One of the major points of my testimony is that not all of the power costs incurred  
15 were reasonable, since they could have been reduced through prudent actions on  
16 the part of Citizens, and the disputed amount is not necessary until it has been  
17 determined by either FERC or a court that it was all necessary.  
18

19 With regard to Mr. Avera's comments about Citizens' ability to attract capital, it  
20 is not clear that this is relevant to a Company that is not a stand-alone company.  
21 Even if it were, his reasoning would suggest that a Commission could not  
22 penalize a company for imprudence because of the financial condition of the  
23 Company. In my view, the financial conditions of a utility cannot always be  
24 "insurance" against penalties for imprudence. I do not believe that regulators  
25 should deny themselves the right to penalize poor management effectively.  
26

27 **Q. Does this conclude your testimony?**

28 A. Yes.



**BEFORE THE ARIZONA CORPORATION COMMISSION**

WILLIAM A. MUNDELL

Chairman

JIM IRVIN

Commissioner

MARC SPITZER

Commissioner

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

DOCKET NO. E-01032C-00-0751

ATTACHMENTS TO

SURREBUTTAL

OF

LEE SMITH

ON BEHALF OF

ARIZONA CORPORATION COMMISSION STAFF

March 13, 2002

**Data Responses in Attachment S-3:**

Staff 7.05 (p.6)

Staff 4.1 (p.7)

Staff 10.1 (p.17)

Staff 10.3 (p.17)

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

**Witness: Sean Breen**

**Data Request No. 7.05:**

Please describe the sequence of negotiations with APS in the spring of 2000.

**Response:**

The sequence of negotiations APS/PWEC in the Spring of 2000 included the following key events:

- **March/April 2000** – Letters were exchanged between Citizens and APS/PWEC concerning billing practices and SIC calculation procedures. Please see the response to Staff Data Request LS 5.11 for copies of this correspondence.
- **April 17, 2000** – Correspondence from APS describing the proposed “hold harmless” modifications to the Power Service Agreement that APS/PWEC would seek in a pending FERC application. Please see the response to Staff Data Request LS 5.16 for a copy of this letter.
- **April 27 – May 18, 2000** - a series of face-to-face meetings to discuss alternative power supply arrangements that led ultimately to the execution of the May 18, 2000 “Terms of a Potential Restructuring...” document. Please see the response to Staff Data Request LS 5.44 for a copy of the May 18, 2000 document.
- **May/June 2000** – The key events during this period included Citizens’ withdrawal of its FERC intervention into the APS/PWEC Market-Based Rates proceeding and the negotiation of the terms of the restructured contract, which ultimately was not executed.

CITIZENS COMMUNICATIONS COMPANY  
ARIZONA ELECTRIC DIVISION'S RESPONSES TO THE  
ARIZONA CORPORATION COMMISSION STAFF'S  
FOURTH SET OF DATA REQUESTS  
DOCKET NO. E-1032C-00-0751

RECEIVED

OCT - 2 2001

October 2, 2001

LEGAL DIV.  
ARIZ. CORPORATION COMMISSION

LAJ 4.1: Re: Application, Page 3, Lines 19 and 20. Provide the key contract provisions that the AEC and APS interpreted differently and provide each party's interpretation.

Respondent: Sean Breen

Response: There were two principal areas of disagreement concerning the interpretation of the contract: the definition of "System Incremental Cost (SIC)" and how SIC was charged for the base block of Schedule A.

In the contract, the definition of System Incremental Cost was limited to purchases "for economic purposes" that "would not otherwise be needed" to serve Citizens' load. Citizens contended that it was not responsible for all of Arizona Public Service's (APS) purchased power costs, but only for economic purchases, i.e., those lower than the avoided cost of APS' high cost generating unit. Under APS' interpretation of the SIC, the hourly incremental cost of all purchases were chargeable to Citizens to the extent it was taking power applicable to SIC billing. [See, Power Service Agreement, section 4.1.1.1, line 16 and 17.]

The second area of dispute related to how the parties interpreted the Schedule A charges. Schedule A includes a "base block" of 100-megawatts each hour, plus the right to take up to 75 more MW each hour during "off-peak" hours. Citizens paid APS a fixed monthly demand charge for the right to take this power. Citizens' interpretation of the contract was that pricing for the base block of Schedule A was based on the embedded cost of the APS system and that this portion of the load should not be subject to SIC pricing. APS took the position that the ability to charge Citizens for the full cost of purchased power was set forth in specific provisions Service Schedules A, B and C, which provided that Citizens "shall be responsible for purchased power costs, and for any other costs incurred by APS in fulfilling its obligations for power and energy under this Service Schedule which otherwise would not have been incurred." [See, Power Service Agreement, Schedule A, Exhibit B, page 2, section III]

Attached is correspondence between Citizens and APS that further details the parties positions:

- Letter dated March 7, 2001 from Russ Mitten, Citizens, to Jack Davis, APS.
- Letter dated March 19, 2001 from Jack Davis, APS, to Russ Mitten, Citizens.

Three High Ridge Park  
Stamford, Connecticut 06905  
(203) 614-5047 telephone  
(203) 614-4651 facsimile  
rmitton@ezn.com

L. RUSSELL MITTEN, *Vice President*  
*General Counsel and Corporate Secretary*

**CITIZENS**  
communications

SM

March 7, 2001

LAD 4.1

**VIA FEDERAL EXPRESS**

Jack E. Davis  
President, Energy Delivery and Sales  
ARIZONA PUBLIC SERVICE COMPANY  
400 North 5<sup>th</sup> Street  
P.O. Box 53999  
Phoenix, Arizona 85072-3999

**RE: Power Service Agreement between Arizona Public Service  
Company ("APS") and Citizens Communications Company  
("Citizens")**

Dear Mr. Davis:

As you know, Citizens has brought to APS's attention very serious concerns about a breach by APS of our Power Service Agreement ("PSA"), resulting in extraordinarily high billings beginning last summer. We have met and corresponded with representatives of APS and Pinnacle West to express our concerns in detail, but we have to date received no constructive response or any willingness to address the fundamental problems we have identified.

Our senior representatives met with you personally in January to impress on you our very grave concerns about this matter. They left that meeting with the understanding that you were directing your staff to review this matter so that you could provide us a response commensurate with the seriousness with which we presented our concerns. Our subsequent contact with your staff some weeks later, which we initiated, received only a cursory and dismissive response to the merits of our contract concerns.

As we have explained repeatedly in our past communications, the "System Incremental Cost" which is a stipulated component of the charges under some of our service schedules with APS is expressly limited to passthrough of power purchase costs where the purchase is "for economic

purposes" that "would not otherwise be needed" to serve Citizens under the PSA. Citizens therefore is not responsible for all of APS's purchased power costs, but only for economic purchases; i.e., those lower than the avoided cost of APS's highest cost generating unit. The PSA does not contain the more expansive definition of "System Incremental Cost" found in some of your other agreements and tariffs. This is by design: it was the clear understanding of all of the representatives of Citizens who negotiated that contract with APS that we would only pay for "economic" purchased power costs, not for the costs of reliability purchases. APS, which had very large generation reserves at that time, knowingly took the risk that it could pass through to Citizens only the costs of APS purchases that took advantage of economic opportunities to buy power for less than APS's generating costs—not the exorbitant costs of your very extensive market trading activity.

We are especially concerned that APS began last summer, for the very first time, to charge Citizens for System Incremental Costs under the baseload portion of Schedule A of the PSA. As you well know, the first 104 megawatts of Schedule A, for which Citizens pays a very substantial demand charge, is and always has been based on the embedded costs of your system units, not on your incremental costs. It evidences a great disrespect for your largest customer that you would even attempt to impose on us a huge new cost burden based on a novel and erroneous interpretation of our long-term agreement.

The result of these breaches of our agreement has been to impose on Citizens excess charges of over \$50 million, and mounting. APS's exorbitant billings also are having a continuing adverse affect on Citizens's efforts to sell its Arizona Electric Division, and present an overhanging threat to growth and economic development in the Arizona counties that Citizens serves. Our ongoing investigation of this matter also suggests other potential problems, including anomalous and unexplained sale and purchase activity by APS and Pinnacle West during periods of high prices that may have adversely affected others in addition to Citizens.

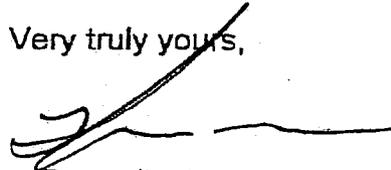
Citizens values its longstanding relationship with APS, and I have always been given to understand that you also value this relationship. That relationship has now been sorely tested. As noted above, Citizens estimates that it has been damaged in the amount of at least \$50 million by APS's breaches of our agreement. Moreover, Citizens will not tolerate any attempted repeat of last summer's experience. If you do not respond to this letter within ten days with a satisfactory proposal for a consensual resolution of this very serious matter, then Citizens will be forced to take appropriate action. In the

Citizens Communications

Jack E. Davis  
President, Energy Delivery and Sales  
ARIZONA PUBLIC SERVICE COMPANY  
March 7, 2001  
Page 3

event Citizens undertakes formal dispute resolution procedures, Citizens reserves the right to assert additional facts and legal bases for recovery.

Very truly yours,



L. Russell Mitten  
Vice President - General Counsel  
& Secretary,

cc: Daniel J. McCarthy

Citizens Communications

MAR 26 2001

LAT 4.1

March 19, 2001

L. Russell Mitten  
Vice President, General Counsel and Corporate Secretary  
Citizens Communications Company  
Three High Ridge Park  
Stamford, CT 06905

Re: Power Service Agreement between Arizona Public Service Company ("APS")  
and Citizens Communications Company ("Citizens")

Dear Mr. Mitten:

This letter is sent in response to your correspondence dated, March 7, 2001, and received by me on March 12, 2001, concerning a dispute by Citizens of its billings under the Power Service Agreement between APS and Citizens.

Although your letter alleges that APS has been somehow lax in responding to your concerns, that simply is not the case. As you know, we have had a number of discussions with Citizens over the past year or so with regard to concerns raised by Citizens. APS has consistently responded to those concerns. When Citizens representatives visited my office in January, I was told, in no uncertain terms, that Citizens was preparing to take an offensive posture against APS. This left us with the impression that Citizens had foreclosed on any option of attempting to resolve differences amicably. APS has never wavered on the proposition that Citizens is a valued customer and we understand only too well the concerns of Arizona load-serving entities faced with historically high power supply costs. APS has closely reviewed Citizens' concerns and the parties' contract in trying to find a mutually acceptable solution to the current dispute. We will continue to be open to further discussions and efforts by APS and Citizens to ameliorate the high power costs faced by Citizens and its customers, within the terms of the contract or modifications thereto that may be mutually agreed to by the parties.

That said, APS continues to strongly believe that its billing of Citizens under the existing contract is in accordance with the terms of the contract. In particular, we find no basis in the contract for APS to assume the cost responsibility for power purchased to meet Citizens' loads. Indeed, your references to System Incremental Costs completely ignores the specific and basic provisions of Service Schedules A, B and C which provide that Citizens "shall be responsible for purchased power costs, and for any other costs incurred by APS in fulfilling its obligations for power and energy under this Service Schedule which otherwise would not have been incurred".

APS • APS Energy Services • Pinnacle West Energy • SunCor • El Dorado

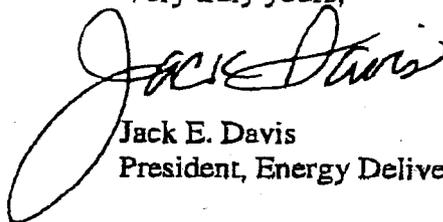
Pinnacle West Capital Corporation 400 North 5th Street, Post Office Box 53999 Phoenix, AZ 85077 3999 602-379-2500

APS Energy Services and APS are subsidiaries of Pinnacle West Capital Corporation; however, APS Energy Services is not the same company as APS. You do not have to be an APS Energy Services customer to receive quality regulated services from APS.

Moreover, the Power Service Agreement between APS and Citizens is a coordination agreement. Under regulatory requirements of the Federal Energy Regulatory Commission with respect to power sales under such coordination agreements, the selling utility must recover at least its out-of-pocket costs of providing such service; otherwise, the utility's other customers might be forced to subsidize the service to the coordination customer. That is why the Agreement has both the System Incremental Cost definition you mention in your letter and the specific reference to Citizens responsibility for purchased power cost. As has been demonstrated by recent events, purchased power costs incurred to provide service to Citizens can result in out of pocket costs to APS which can dramatically exceed the power supply charges applicable if service to Citizens is provided from the APS system. By focusing only on your limited view of the System Incremental Cost definition in the Agreement, your letter effectively attempts to write the purchased power provision out of the contract, in violation not only of the express terms of the contract, but of federal regulatory requirements as well.

We remain committed to trying to maintain the good business relationship we have enjoyed over the years, and are willing to discuss alternatives to the present situation. As noted, we strongly disagree with the positions stated in your letter, are confident that our interpretation of the Agreement is correct and are prepared to litigate this matter vigorously. However, we see little to be gained, by either party, from extended litigation concerning the Agreement and both parties' power supply and risk management activities. Instead, I would like to suggest that we commit during the next three weeks to meet in person and discuss this matter and possible solutions that are in the best interests of both Citizens and APS. If Citizens is interested in pursuing such discussions, please contact me and we can proceed accordingly.

Very truly yours,



Jack E. Davis  
President, Energy Delivery and Sales

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

**Witness: Sean Breen**

**Data Request No. 10.1:**

According to the response to Data Request LS 5.50, if APS dispatches the Valencia turbines, Citizens will pay the fuel costs. Will Citizens also pay the O&M costs of the units?

**Response:**

Yes.

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

**Witness: Sean Breen**

**Data Request No. 10.3:**

Please estimate what the cost to Citizens will be if APS dispatches the units for 1000 hours. Specify all assumptions used in making this estimate.

**Response:**

Based on a typical output capacity, no nominal fuel cost, efficiency data and current labor costs, an estimate for Citizens' incremental cost for the specified operation of the Valencia turbines is as follows: (Assumes continuous 6 days/week, 16 hours/day of operation).

Fuel:

44 MW X 1,000 hours X 127.5 gallons/MWh X \$1.00/gallon = \$5,610,000

Incremental Operator Labor:

Second-Shift Operator (9 weeks @ \$1,312/week)	\$7,872
Weekend Operator (9 weeks @ \$525/week)	4,725
Engineering Technician (9 weeks @ \$150/hr X 50 hrs.)	<u>67,500</u>
	<u>80,097</u>
Total Cost	\$ 5,690,097
Divided by Megawatt-Hours Generation	<u>44,000</u>
Average Incremental Cost (per MWh)	<u>\$ 129.32</u>

**BEFORE THE ARIZONA CORPORATION COMMISSION**

WILLIAM A. MUNDELL

Chairman

JIM IRVIN

Commissioner

MARC SPITZER

Commissioner

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

DOCKET NO. E-01032C-00-0751

SURREBUTTAL TESTIMONY

OF

DOUGLAS SMITH

ON BEHALF OF

ARIZONA CORPORATION COMMISSION STAFF

March 13, 2002

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

2 A. My name is Douglas Smith. I am the Technical Director of LaCapra Associates  
3 located at 333 Washington Street, Suite 855, Boston, Massachusetts 02108.

4 **Q. On whose behalf are you testifying in this docket?**

5 A. I am appearing on behalf of the Arizona Corporation Commission Staff ("Staff").  
6 I have previously presented direct testimony in this docket.

7 **Q. What is the purpose of your testimony in this docket?**

8 A. My surrebuttal testimony responds to rebuttal testimony of the Arizona Electric  
9 Division of Citizens Communications Company ("Citizens") with respect to the  
10 outlook for electricity market prices in the summer of 2000, and the steps that  
11 Citizens could have taken to reduce its exposure to those prices. I primarily  
12 address the rebuttal testimony of Mr. William Avera.

13 **Q. Please summarize your findings.**

14 A. My primary findings can be summarized as follows:

- 15
- 16
- There was considerable evidence, well in advance, that western spot market prices could increase greatly in Summer 2000;
  - Contrary to Mr. Avera's suggestions, I do not claim that it was certain that large and sustained price increases would occur. A wide range of price outcomes was possible;
  - Other utility buyers of power in the West recognized the potential for large market price increases, and took steps to reduce their exposure;
  - Based on what Citizens knew about the Old Contract with APS, and on available information about market conditions, I believe that Citizens should have considered a combination of potential steps to reduce its exposure to high market price outcomes. These steps could have significantly reduced the PPFAC bank balance that Citizens now seeks to recover.
- 17
- 18
- 19
- 20
- 21
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- 23
- 24
- 25
- 26
- 27

28

29 **Q. Does Mr. Avera's presentation fairly represent the outlook for western**  
30 **market prices, based on information available in 1999 and early 2000?**

1 A. Mr. Avera does not address this critical question directly. Mr. Avera repeatedly  
2 emphasizes that the *actual magnitude and duration* of market price increases that  
3 occurred in the west were not anticipated. For example (page 8): "...these price  
4 changes were beyond any reasonable expectations of market participants and  
5 impossible to predict. Utility planners and other market participants were  
6 blindsided by the magnitude and wide reach of the price spikes in California."  
7 Mr. Avera's testimony contains several similar observations.

8 I agree that the actual price increases that occurred in the western electricity  
9 markets from mid-2000 through mid-2001 were extreme. I don't expect that any  
10 market participant's base case forecast predicted the actual duration and  
11 magnitude of price increases. But this is not the real issue, because power  
12 planning and transaction decisions should not reflect only base case analysis.  
13 Market participants also assess the range of potential outcomes that might occur,  
14 and the associated probabilities. Further, market participants do not generally  
15 wait until an adverse outcome is evident before hedging against it. They hedge in  
16 advance, to protect against a potential adverse outcome which would be  
17 undesirable or unacceptable. La Capra Associates and its clients use such  
18 assessments, along with the client's financial tolerance for particular outcomes, to  
19 determine appropriate hedging strategy and to support specific transactions.

20 What is important in the context of this case is whether Citizens should have seen  
21 a real possibility for substantial price increases, even increases less extreme or  
22 shorter in duration than the ones that actually occurred. I believe that Citizens  
23 should have seen this possibility. There was plenty of advance warning that  
24 western market prices were likely to increase in 2000, and that there was some  
25 significant probability that the magnitude of the increases would be large.

26 **Q. What evidence supported this conclusion?**

27 A. As detailed in my direct testimony, the following evidence was available from  
28 easily obtainable sources well before prices actually increased:

- 1 • Capacity margins in WSCC, including the Southwest, were declining due to a  
2 combination of demand growth and limited capacity additions. Adverse load  
3 or generator outages would produce a tight supply/demand balance;
- 4 • Experience in eastern U.S. markets during 1998 and 1999 had demonstrated  
5 that temporary shortages of electricity can produce large increases in spot  
6 market prices. For example, market price spikes in Summer 1998 had  
7 produced monthly average onpeak prices of \$263/MWh and \$149/MWh at the  
8 Cinergy hub. These market price increases, which were concentrated in  
9 relatively few days, raised the *annual average* price of energy at Cinergy by  
10 over \$12 per MWh. In July 1999, onpeak prices at Cinergy reached an even  
11 higher monthly average of \$320/MWh. Outcomes like these were often not  
12 foreseeable in advance based on forward market price quotations.
- 13 • At least some market observers explicitly discussed the risk of western price  
14 increases. For example, in 1999 the ICF/Kaiser Consulting Group warned<sup>1</sup>  
15 that "The West stands at least a one-in-three chance of experiencing price  
16 spikes similar to those seen in the Midwest during the summer of 1998."
- 17 • Buyers and sellers of energy recognized the risk. During late 1999 and early  
18 2000, forward prices for Summer 2000 deliveries at Palo Verde were well  
19 above historical average spot prices. These prices indicated that buyers and  
20 sellers saw a real likelihood of higher spot market prices, and at least some  
21 buyers wanted to protect themselves against much higher price outcomes.  
22 California Block Forward Market "(BFM)" prices were also up.

23 **Q. Were there additional advance signs of trouble for 2000 prices?**

24 **A.** Yes, there were several. First, the characteristics of the western electricity market  
25 were well known. For example, the scale of the western market (the annual peak  
26 demand in WSCC amounted to about 129,000 MW) was smaller than the regional  
27 markets in the east, which are part of interconnected electric systems on a scale of  
28 several hundred thousand MW. When adverse outcomes (e.g., generating unit  
29 outages, high regional electricity demand) occur in the West, less help is available  
30 from neighboring regions. The western system also depends substantially on  
31 hydroelectric production, which can vary significantly from year to year, and it  
32 relies considerably on the transmission of power over long distances. These  
33 factors make the western market relatively susceptible to swings in supply and  
34 demand conditions. In addition, several of the price drivers – particularly in the  
35 California market - were correlated, so that adverse outcomes for one would tend  
36 to trigger adverse outcomes in the other. For example, low hydro production and

1 high electricity demand not only tightens the supply/demand balance, but also  
2 increases demand for natural gas and air emission allowances. Significantly, in  
3 recent years the California market had not yet experienced a year in which hydro  
4 production was low and weather was very hot. This type of information was  
5 available from public sources.

6 In a March 2000 presentation to the California Power Exchange, CEC noted the  
7 potential for a tight summer, citing the following factors:

- 8 • Growth of electricity consumption during 1999, despite a cool summer;
- 9 • Declining peak demand reserve margins for WSCC, particularly in  
10 California and the Southwest;
- 11 • About 28 percent of California peak demand is weather-sensitive air  
12 conditioning load.

13  
14 According to CEC, other government agencies and private analysts were making  
15 similar findings.

16 **Q. Did trade press articles address the potential for market price increases in**  
17 **Summer 2000?**

18 A. Yes. While Mr. Avera states that several sources that did not sound advance  
19 alarm about summer market conditions, a number of articles published in *Power*  
20 *Markets Week* during the period of January 2000 through May 2000 did. The  
21 articles discuss two main drivers of electricity prices, demand and hydro  
22 availability. The January 24, 2000 article titled "Western Futures Close Higher;  
23 Traders Wonder: Is Supply Glut Finally Over?", talks about the unusually high  
24 level of prices despite the presence of strong load. One trader is quoted as saying  
25 "We've got \$38 power in California with no load. It looks as though the West is  
26 shaping up to be quite a bit tighter than its reputation would suggest." The article  
27 goes on to state that "The region's strong economy may be setting a new price  
28 floor that could have implications for the summer..."

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<sup>1</sup> As reported in *Power Markets Week* June 7, 1999.

1 The February 28, 2000 issue of *Power Markets Week* reports the remarks of CEC  
2 Chairman William Keese warning of power shortages in California if the region  
3 experiences a heat wave. The article further says "The comments added more  
4 momentum to the upward trending market that has already been influenced by  
5 predictions of below-normal hydro supplies and forecasts of strong load growth."

6 Questions about the availability of hydro supplies were surfacing in the trade  
7 press as early as February. The February 14, 2000 issue of *Power Markets Week*  
8 reports the release of the North West River Forecast Center's latest forecast of  
9 Columbia River Basin flows. The report is a revision to an earlier forecast that  
10 revises down the April through September flows from 106% of normal to normal.  
11 The article quotes one trader as saying, "We've had plenty of water and mild  
12 temperatures and haven't been able to get daily prices south of \$30. If the flow  
13 forecasts continue to drop, it could be a very tight summer." The subsequent  
14 issue (February 21, 2000) of *Power Markets Week* reported on the release of  
15 another revision to the Northwest River Forecast Center's flow forecast. The  
16 revised flow forecast predicted the Columbia River Basin flows to be below  
17 normal, down from the previously forecast normal flows. These articles warn of  
18 reduced flows well in advance of the summer.

19 **Q. Was the market price outlook for 2000 affected by changes in ownership of**  
20 **California generating plants?**

21 **A.** Since the California PX market began operation in 1998, a substantial amount of  
22 the generating capacity in California had changed hands. Heading into 2000, the  
23 resulting ownership of supply in the market was meaningfully different from what  
24 it was in 1998 and 1999. Significant capacity had shifted from vertically  
25 integrated utilities – with offsetting load obligations to serve retail customers – to  
26 merchant generating companies with an incentive to increase prices and revenues.  
27 Based on these incentives, it was reasonable to expect that the new owners might  
28 bid the output from their plants more aggressively (i.e., at higher prices) than the  
29 previous utility owners, putting upward pressure on wholesale market prices.

1 **Q. Should Citizens have known with certainty that western spot market prices**  
2 **would turn out as high as they actually did?**

3 A. No, the duration of the price increases that actually occurred would have been  
4 very difficult to anticipate. A realistic base case price outlook would clearly have  
5 been lower, at least over the entire period from May 2000 to June 2001. Just as  
6 clearly, though, it would have been appropriate to anticipate some significant  
7 probability of large spot price increases.

8 I emphasize this point because I believe that Mr. Avera has unfairly characterized  
9 Staff's position. Mr. Avera repeatedly suggests that in Staff's view the actual  
10 price increases should have been obvious in advance. For example, Mr. Avera  
11 states (page 16, line 29) that "If the rapid run-up in power prices that occurred  
12 subsequently had been as evident as Ms. Smith alleges, great fortunes could have  
13 been won..." Similarly Mr. Avera states (page 6, line 8) that "Ms. Smith's  
14 criticism of the AED's response to higher power bills largely rests on the  
15 presumption that the unprecedented conditions in wholesale power markets that  
16 occurred in the summer of 2000 were vividly apparent in late 1999." These are  
17 not our positions.

18 What I do believe is that there was solid evidence, in advance, of a tightening  
19 market. Citizens should have seen that spot market prices were likely to increase  
20 in 2000, and should have been aware of a significant possibility that the increases  
21 would be large.

22 This conclusion is informed by the information described above, combined with  
23 my experience as a power planner. During the past ten years I have managed the  
24 power supplies of two small electric utilities. In this role, I have been responsible  
25 for identifying and managing market price risk, developing procurement  
26 strategies, negotiating with potential trading partners, and developing contract  
27 terms. I have helped numerous other clients (including utilities and retail end  
28 users) to develop appropriate power procurement and risk management strategies,  
29 based on their respective tolerances for price uncertainty. I also have substantial

1 experience with longer term electricity planning analyses, and I have conducted  
2 detailed forecasts of electricity spot market prices in numerous geographic  
3 markets. In summary, much of my professional experience has been helping  
4 clients -- many of them market players of a limited scale, like Citizens -- to address  
5 power supply issues like those Citizens has faced. These clients, or La Capra  
6 Associates on their behalf, use the types of information sources that I have cited  
7 in the previous pages to assess the market outlook and their risk exposures.

8 **Q. What were the implications of this outlook for Citizens?**

9 A. As explained in Ms. Smith's direct testimony, Citizens knew that APS would be a  
10 net purchaser, at least in the summer, in order to meet its total load requirements.  
11 Notwithstanding Citizens' view that reliability purchases should not be included  
12 in the SIC, experience from 1998 and 1999 had shown that under APS'  
13 interpretation of the Old Contract, high prices for APS market purchases would be  
14 passed through to Citizens through the SIC calculation.

15 It is also important to consider how much of Citizens' load was exposed to market  
16 prices. Because the Old Contract served essentially Citizens' entire load, the  
17 possibility of large spot market price increases - even if much less extreme than  
18 those that actually occurred - would have translated to the possibility of large  
19 increases in purchased power costs and, therefore, the PPFAC bank balance.

20 Given the magnitude of the potential market price exposure, and the fact that the  
21 exposure could apply to essentially Citizens' entire load, I believe that CUC  
22 should have been monitoring market conditions carefully during 1999 and 2000,  
23 and should have given careful consideration to the available steps that could have  
24 hedged its exposure to high market price outcomes.

25 **Q. What hedging steps could Citizens have explored?**

26 A. As explained in Ms. Smith's direct testimony, Citizens should have given  
27 consideration to at least the following steps:

- 1           • **A forward power purchase.** The purpose of this step would be to  
2 purchase a block of energy in advance, at a fixed price. One way to  
3 accomplish this would be to have APS make the purchase, and pass the  
4 cost through to Citizens through the Old Contract. The price to Citizens  
5 would presumably have had to include some fee to APS (Ms. Smith's  
6 calculation assumes \$2/MWh) for its time to implement the transaction.
- 7           • **A financial hedging transaction.** This option would entail a contract  
8 with another party, the effect of which would be to reduce the effect of  
9 spot market price increases on Citizens' net costs. For example, in a  
10 "contract for differences" Citizens and the counterparty might agree on a  
11 reference price for spot energy prices at Palo Verde. If actual spot prices  
12 turned out higher than the reference price, Citizens would be paid the  
13 difference. If actual spot prices turned out lower, Citizens would pay the  
14 difference. No power would be exchanged, only money. One advantage  
15 of such a transaction would be that Citizens could conduct it with a party  
16 other than APS.
- 17          • **Operation of Valencia.** By generating at Valencia, Citizens would  
18 reduce the volume of energy that it needed to purchase under the APS  
19 contract. Valencia's operating costs are relatively high, so it would only  
20 be cost-effective to generate at times when market prices are higher. The  
21 decision as to whether and when to operate each day could be made in  
22 collaboration with APS, or even separately based on broker quotations and  
23 other market information. Even a few hundred hours of operation during  
24 tight market conditions would justify the effort of implementing such an  
25 approach.

26  
27 One of these hedging steps, or a combination, could have substantially reduced  
28 Citizens' exposure to high spot market price outcomes. As explained by Ms.  
29 Smith, it does not appear that Citizens identified its exposure to high market price  
30 outcomes in a timely way, or adequately pursued these steps to reduce its  
31 exposure. Instead, during early late 1999 and early 2000, Citizens relied  
32 exclusively on its attempts to renegotiate the Old Contract with APS.

33 **Q. Heading into 2000, did other market participants take steps to protect**  
34 **themselves from potential market price increases?**

35 **A.** Yes. Mr. Avera emphasizes that the dramatic price volatility and prolonged  
36 increase in western market prices were not foreseen by market participants. For  
37 example, he states (page 16, line 23) that "...even large utilities with highly  
38 sophisticated trading operations were blindsided by the protracted crisis that  
39 began in May 2000." I recognize that the magnitude and (particularly) the

1 duration of the market price increases were extreme, and I don't claim that  
2 Citizens should have expected the actual magnitude and duration of the increases.

3 Mr. Avera does not directly address the question that is much more relevant to the  
4 evaluation of Citizens' performance: did other market participants foresee the  
5 potential for price increases, and act to protect themselves? At least several  
6 important buyers – California electric utilities – did.

7 Specifically, Southern California Edison ("SCE") and Pacific Gas & Electric  
8 ("PG&E") requested and received authority to make purchases in the California  
9 Power Exchange's Block Forward Market ("BFM")<sup>2</sup>. In July 1999, the utilities  
10 received authorization to purchase up to one third of their historical minimum  
11 loads. By March 2000, SCE and PG&E had requested and received permission to  
12 make BFM purchases up to their full net short positions. The California Public  
13 Utilities Commission's reasoning for the increased limits was that "...the utilities  
14 require additional flexibility to insure against price spikes."<sup>3</sup> The utilities made  
15 substantial use of their authority. For example, at least 3,750 MW of BFM  
16 purchases were made for delivery during July and August 2000 in the SP-15 zone;  
17 SCE stated that it was the largest buyer. I have not researched the total BFM  
18 purchases for NP-15 in the same fashion, but the fact that PG&E sought  
19 additional BFM purchasing approval indicates that it made substantial BFM  
20 purchases as well.

21 I have not conducted a comprehensive survey of the steps that other market  
22 participants took to hedge their market price exposure. However, trade press  
23 reports indicate that throughout Spring 2000, there was regular bilateral trading  
24 activity for summer deliveries at Palo Verde. Again, these buyers were willing to  
25 make forward purchases - at prices well above historical spot levels - to protect  
26 themselves against the potential for even higher spot price outcomes.

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<sup>2</sup> Block forward contracts were for the physical delivery of a specified amount of power during peak hours of the delivery month, at a fixed price.

<sup>3</sup> Resolution E-3658, March 16, 2000.

1 **Q. Would the hedging steps that you described above have significantly reduced**  
2 **Citizens' power costs, and therefore the amount of deferred costs that**  
3 **Citizens seeks to recover in this proceeding?**

4 A. Yes. Mr. Avera's testimony (page 27, line 25) "...were unlikely to have a  
5 significant impact on the PPFAC bank balance." Mr. Avera also suggests (page  
6 22, line 19) that the purchased power cost increases that Citizens has experienced  
7 were beyond the control of management. I disagree because the hedging steps  
8 that are discussed above, and in Ms. Smith's testimony, could have limited the  
9 cost increases by a significant amount.

10 First, Ms. Smith showed in her direct testimony that a 100 MW onpeak forward  
11 purchase, replacing Schedule A energy priced at the actual Schedule A SIC<sup>4</sup>,  
12 would have saved roughly \$10 million over a three-month period. Contrary to  
13 Mr. Avera's suggestion, this example is not based on hindsight. The assumed  
14 forward purchase reflects prices that actual purchasers were paying during the  
15 first four months of 2000, including March and April when pessimistic  
16 information was being reported and market prices were increasing. Just as  
17 important, Ms. Smith's hedging example addresses only part of Citizens' load,  
18 only in the onpeak hours, and only for three months. Larger or longer purchases  
19 would have, as it turns out, saved much more.

20 It is also important to recognize that Ms. Smith's estimate of hedging savings is  
21 conservative, because it assumes that the presence of an additional 100 MW  
22 forward purchase in APS' supply portfolio would not have displaced any of the  
23 high-priced purchases that APS made in the spot market (e.g., the day before  
24 delivery) and passed through to Citizens through the SIC mechanism. On many  
25 days, however, the last purchases that APS made were much more costly than its  
26 other purchases that were made in advance. If the forward purchase had actually  
27 enabled APS to purchase less high-cost energy from the spot market (and this

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<sup>4</sup> Citizens has indicated that it did not expect Schedule A to be exposed to SIC pricing. If Citizens had pursued the forward purchase approach with this understanding, a transaction could have been designed to hedge the cost of power under Schedule B and/or Schedule C, resulting in comparable or higher savings.

1 would be a reasonable outcome), it would have had the additional effect of  
2 lowering the SIC price that applied to the remainder of Citizens' load. The  
3 resulting savings to Citizens from a forward energy purchase could therefore have  
4 been significantly higher than Ms. Smith's \$10 million estimate.

5 It is not possible to cleanly demonstrate the savings from a financial hedge,  
6 because such transactions are not always conducted in standard amounts using  
7 standard terms, and are not typically reported in the trade press. However, parties  
8 conducting financial hedging transactions (such as a contract for differences) face  
9 the same market risks and opportunities as those in the physical market. It is  
10 therefore reasonable to assume that if Citizens were able to arrange a financial  
11 hedging transaction, the net benefits would be of similar magnitude as those  
12 discussed above for a physical purchase.

13 Finally, operation of the Valencia generating units – even for limited periods -  
14 could have helped.

15 **Q. Mr. Breen's rebuttal testimony indicates that Citizens did not take actions to**  
16 **run Valencia for economic reasons because it didn't anticipate the actual**  
17 **market price increase, and its running costs were almost "double the highest**  
18 **month of forward prices." (Rebuttal p. 30) Is this explanation convincing?**

19 No, for the following reasons. First, as explained earlier in my rebuttal testimony,  
20 Citizens should have been aware that spot market prices could turn out higher  
21 than forward prices. The ability to dispatch Valencia would be insurance against  
22 this possibility, particularly against outcomes involving large temporary price  
23 spikes.

24 Second, Mr. Breen's comparison of Valencia running costs to forward prices  
25 misses a critical point: forward market price quotes typically reflect deliveries  
26 over all peak hours in a month, and therefore reflect expectations about average  
27 prices. Even if the average of spot market prices during these hours turn out  
28 similar to the forward prices (and below Valencia's running costs), subsets of  
29 hours during particular days can turn out much higher. Such temporary price

1 spikes had already occurred in eastern markets during 1998 and 1999, and they  
2 occurred in the west during Summer 2000. For example, on particular days APS  
3 purchased (and Citizens paid for, through the SIC) spot market energy at prices of  
4 \$700/MWh (i.e., 70 cents/kWh) or more. Even at a variable cost of  
5 approximately 13 cents per kWh, the Valencia units would have been much less  
6 costly. It would have been possible for Citizens to identify such days as they  
7 were occurring (whether through APS, with the assistance of a broker, or other  
8 means), and to arrange for Valencia operation accordingly. Had the Valencia  
9 units produced during such conditions (I assume for this example a 30 MW  
10 average output), they would have produced a net savings to Citizens of about  
11 \$17,000 per hour. The hourly SIC prices from APS indicate that over several  
12 months during 2000, operation of Valencia for only several hundred hours during  
13 high-price days could have provided net energy cost savings of between \$1  
14 million and \$2 million<sup>5</sup>. In fact, operating for even 100 hours on the highest-  
15 priced days could have saved on the order of \$1 million. Even if Citizens had not  
16 expected spot market prices to spike as often as they actually did, it should have  
17 been evident that the ability to run Valencia periodically would have some  
18 significant value.

19 **Q. What are the implications of the hedging steps that you have discussed?**

20 A. The actual savings from each of these hedging steps would have varied somewhat  
21 based on the details of when and how they were implemented. The key point is  
22 that Citizens had the ability to pursue steps to limit its exposure to high market  
23 prices, and that a combination of these hedging steps could have reduced its  
24 purchased power costs (and the current PPFAC request ) by millions of dollars.  
25 Ms. Smith has shown that Citizens did not adequately pursue these options, and  
26 instead relied primarily on its ability to successfully renegotiate the Old Contract.  
27 As it turned out, Citizens was not successful.

28 **Q. Does this conclude your testimony?**

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<sup>5</sup> If the operation of Valencia displaced APS spot market purchases and lowered the SIC prices that APS charged for the remainder of Citizens' load, the savings would be even greater.

1 A. Yes, it does.