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BEFORE T   OMMISSION

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

DOCKET NO.
E-01032C-00-0751

NOTICE OF FILING

The Arizona Utility Investors Association hereby provides notice of filing the Direct Testimony of Walter W. Meek as required by the Commission's procedural order in the above-captioned matter.

DATED THIS 8TH DAY OF FEBRUARY, 2002.

Walter W. Meek

WALTER W. MEEK, PRESIDENT

CERTIFICATE OF SERVICE

Original and ten (10) copies of the referenced Testimony were filed this 8th day of February, 2002, with:

Docket Control
Arizona Corporation Commission
1200 W. Washington Street
Phoenix, AZ 85007

Arizona Corporation Commission
DOCKETED

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Copies of the referenced Testimony were hand-delivered this 8th day of February, 2002, to:

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Walter W. Meek

Walter W. Meek

DIRECT TESTIMONY

OF

WALTER W. MEEK

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Walter W. Meek. My business address is 2100 North Central Avenue, Suite 210, Phoenix, Arizona 85004.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am president of the Arizona Utility Investors Association ("AUIA" or "Association"), a non-profit organization formed to represent the interests of shareholders and bondholders who are invested in utility companies based or doing business in the state of Arizona.

Q. ARE SOME AUIA MEMBERS SHAREHOLDERS OF THE APPLICANT IN THIS PROCEEDING?

A. Yes. AUIA has approximately 6,500 individual members, including common shareholders of Citizens Communications Company ("Citizens," formerly Citizens Utilities), the parent company of the certificate holder in this application.

Q. WHAT IS YOUR BACKGROUND IN REPRESENTING SHAREHOLDER CONCERNS AND INTERESTS?

A. I have been president of AUIA for nearly eight years. Prior to that, my consulting firm managed the affairs of the Pinnacle West Shareholders Association for 13 years. During these periods we have represented shareholders in numerous rate cases and other regulatory matters and have published many position papers, newsletters and other documents in support of shareholder interests.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I am here to represent the views of the equity owners of Citizens Communications in the application of Citizens' Arizona Electric Division ("AED") to recoup its unrecovered costs in serving its customers in Mohave and Santa Cruz counties.

Q. WHAT IS THE MAGNITUDE OF THESE UNRECOVERED COSTS?
A. At this point in time, I estimate they total more than $100 million.

Q. AND WHO IS CURRENTLY FUNDING THESE UNRECOVERED COSTS?
A. The shareholders of the company.

Q. WHY ARE THESE COSTS UNRECOVERED?
A. The short answer is that since approximately May of 2000, it has cost Citizens more to provide electric energy to its customers than it is authorized to collect in the rates approved by this Commission.

Q. WHAT IS THE REASON FOR THAT?
A. The reason is somewhat complicated and begins with the fact that Citizens has no base load or intermediate generation of its own. For many years, it has obtained wholesale electricity under a full requirements contract with Arizona Public Service Company ("APS"). In addition, Citizens buys transmission service from the Western Area Power Administration ("Western").

Q. HOW AND WHEN DID THE UNDER-RECOVERY OCCUR?
A. In the spring and summer of 2000, the western power markets fell into complete disarray, as demand outran supply and wholesale prices reached unheard of levels. Under the contract between Citizens and APS which was in effect at that time, APS believed it could adjust its price to Citizens to reflect the incremental cost of APS' purchases in the wholesale market.

Q. WHAT WAS THE IMPACT ON CITIZENS?
A. From May through August of 2000, Citizens' power costs ranged from 11.4 cents per kWh to 17.5 cents, compared with a normal cost of about 4 to 5 cents. Under its existing tariff, Citizens can charge only about 5.2 cents for the power component of its rates. As a result, by September 2000, Citizens had a deficit of $54.2 million in its Purchased Power and Fuel Adjustment Clause ("PPFAC") bank.

Q. WERE THERE CONTINUING LOSSES?
A. Yes. Citizens experienced higher than normal charges through May of 2001 when the wholesale market again produced price peaks above 17 cents.

Q. WHAT HAPPENED THEN?
A. Citizens and APS went to the bargaining table and negotiated a new contract which featured a fixed wholesale rate of about 5.9 cents per kWh with no adjustments for market conditions. Pending approval from the Federal Energy Regulatory Commission ("FERC") the contract took effect June 1, 2001, with a duration of seven years.

Q. DID THAT STOP THE CASH HEMORRHAGE?
A. For the most part, but not entirely. The rate that APS charges under the new contract is higher than the amount Citizens can recover from its customers, so Citizens continues to bleed, but not as severely. That's one reason why I estimate that the PPFAC deficit now exceeds $100 million, even though the Citizens filing accounts for only $87 million.

Q. IS THERE MORE THAN ONE COMPONENT TO CITIZENS' REQUEST?
A. Yes. There is the recovery of the PPFAC bank deficit, including an increment to account for future carrying charges on the deficit. There are also surcharges to cover the incremental cost increase under the new APS contract plus a price hike imposed by Western. Altogether, they add up to an increase of 2.7 cents per kWh.

Q. YOU MENTIONED CARRYING CHARGES.
A. Citizens has advanced more than $100 million to pay for its customers' power needs. That is nearly as much as the electric division's fair value rate base. At Citizens' authorized rate of return, it represents a loss to the company's shareholders of about $500,000 a month. Citizens proposes a carrying charge of 6 percent per annum to compensate.

Q. HOW DOES THE PASSAGE OF TIME AFFECT CARRYING CHARGES?
A. Every month that goes by without a Commission order results in the permanent loss of prior carrying charges. It is no different than if Citizens had built an entire electric system and was forced to operate it for free.

Q. WHEN DID AUIA FIRST BECOME INVOLVED IN THIS ISSUE?

A. During the summer of 2000, when the situation in California was coming to light, we learned that Citizens was experiencing problems similar to those that were surfacing at San Diego Gas & Electric. I had brief discussions with people at APS and Citizens about the situation and I alerted my Board of Directors that a potentially serious problem was developing in Citizens' service territory.

Q. WHAT HAPPENED AFTER THAT?

A. In September 2000, Citizens filed its initial plan to recover the PPFAC deficit it had incurred that summer. AUIA intervened. In October 2000 and again in March 2001, we described the worsening situation in Mohave and Santa Cruz counties for several thousand readers of our newsletter. We called the Citizens service area "Little California."

Q. WHY DID YOU DO THAT?

A. To give some perspective to the situation and, frankly, to apply a little pressure. Arizona was collectively patting itself on the back for avoiding California's woes. We were concerned that everyone involved – the two companies, the Commission, even the Governor's office – was misjudging the potential consequences of continuing the status quo.

Q WHAT DID YOU THINK NEEDED TO BE DONE?

A. I thought the two companies needed to negotiate a contract that reduced Citizens' exposure to the wholesale market. I was concerned that if Citizens had to endure another summer like 2000, the deficit could have reached $150 million before the Commission would act.

Q. DID YOU TAKE ANY OTHER ACTION?

A. In April 2001, I conveyed my deepening concern to the AUIA Board. The Board instructed me to stay involved but not to take sides on issues that were disputed by the companies. I then spoke to executives of both companies about AUIA's perception that a new contract should be negotiated and that a standoff between the companies benefited no one.

Q. DO YOU THINK AUIA INFLUENCED THE OUTCOME?
A. I have no evidence that we did.

Q. DID AUIA PARTICIPATE IN THE NEGOTIATIONS?
A. No.

Q. WERE YOU KEPT INFORMED OF THE PROGRESS?
A. Not in any detail. I was generally aware that talks were under way, but I had no inside information.

Q. DID A DISPUTE ARISE BETWEEN THE COMPANIES?
A. Yes. In retrospect, it was very important because it continues to cast a shadow over this proceeding and Citizens' legitimate need for relief.

Q. WHAT WAS THE NATURE OF THE DISPUTE?
A. After Citizens' costs under the APS contract spiked in May and June of 2000, Citizens sought an explanation from APS. It developed that the two companies had very different interpretations of language in the contract that APS relied on to adjust Citizens' charges to reflect market conditions.

Q. WHAT WERE THE COMPANIES' POSITIONS IN THE DISPUTE?
A. When Citizens publicly disclosed its mounting deficit, it asserted that APS had misinterpreted the contract and that the deficit was caused mainly by APS overcharges. APS maintained that it had construed the contract and administered it correctly. Both sides were firm in their positions.

Q. HAVE YOU SEEN THE LANGUAGE IN QUESTION?
A. I have read the contract. I am no expert in wholesale electric transactions, but from a lay perspective I would say that the language in question might be open to differing interpretations.

Q. IN YOUR VIEW, IS THERE ANYTHING WRONG WITH THE PROVISION AS APS INTERPRETED IT?
A. In general, no. During the summer, APS has to buy power in excess of its generating capabilities for its own retail customers and Citizens. One would expect APS to pass along the costs they incur in the open market.

Q. DID THIS PROVISION RAISE ANY WARNING FLAGS ?

A. No. As I will demonstrate later in my testimony, all of the parties involved in Citizens' regulatory matters after this contract was negotiated thought it would result in lower costs. None of them thought prices would go up.

Q. WHAT ELSE OCCURRED IN THE DISPUTE?

A. Citizens also announced that it would conduct an "audit" of APS' handling of the transactions under the contract.

Q. WAS THAT A CONSTRUCTIVE MOVE?

A. In my view, the audit had no chance of succeeding. Worse than that, it created unrealistic expectations that are still being felt today and it provided an excuse for inaction. At the open meeting to consider Citizens' first recovery plan, which was filed Sept. 28, 2000, the Staff urged the Commission to postpone action until after Citizens filed a report on the results of its audit. The Commission agreed.

Q. WHAT WERE THE RESULTS OF THE AUDIT?

A. It was never completed. The audit was constructed in three phases. As Mr. Breen indicated in his direct testimony, Citizens finished the first two phases and found no empirical evidence that APS had miscalculated the power deliveries or misapplied the formulas in the contract.

Q WHAT HAPPENED TO PHASE III?

A. Phase III was more difficult. I believe it required an analysis of how APS operated its power supply and trading operations during the summer of 2000 in order to determine whether its incremental purchases in the wholesale market were appropriate. That required APS' cooperation.

Q. WHAT DID APS DO?

A. According to Citizens, APS refused to cooperate on grounds that it wasn't required to do so under the terms of the contract. I believe APS had other reasons. In today's competitive environment, most utilities would regard such operating information as proprietary. In addition, why would they divulge such information to somebody who was threatening to sue them?

Q. WHERE DID THAT LEAVE CITIZENS?

A With two combative options, both of them bad. They could take their contract dispute with APS to FERC or they could file suit in federal court.

Q. WHY WERE THESE OPTIONS UNDESIRABLE FOR CITIZENS?

A. FERC had previously approved the contract and APS is very experienced at working in that arena. In either case, Citizens would have faced a couple of years of litigation and significant extra cost, with no assured result. In the meantime, the meters would have continued running in Mohave and Santa Cruz counties and the Commission apparently would not have intervened.

Q. DID CITIZENS CHOOSE EITHER OF THESE OPTIONS?

A. No. They took the only available course of action that made sense. They went to the bargaining table with APS and negotiated a new contract.

Q. WAS IT WISE FOR CITIZENS TO CONTINUE TO DEAL WITH APS?

A. I don't think they had a choice. Citizens couldn't risk the consequences of another summer and fall under the existing contract. APS had a binding agreement through the year 2011, so another supplier wasn't feasible.

Q. WAS THE NEW CONTRACT A GOOD DEAL?

A. I can't second-guess the price they agreed to one way or the other, but this was during the period when the State of California was negotiating 20-year contracts at 7 cents per kWh. Compared to the spot market at the time and the California transactions, it certainly appears reasonable. Besides, a long term power contract is a hedging instrument and I think you have to view it in terms of risk.

Q. WHAT SORT OF RISK?

A. One reason for engaging in a power supply agreement is to provide an appropriate balance between upside and downside risk. A fixed price contract like this one caps the upside risk at the contract price, in this case about 5.9 cents per kWh. Citizens' average cost from May 2000 through May 2001 was 11.4 cents and the peak was 19 cents. So, you could reasonably conclude that the new contract provides protection in a range of 5.5 cents to 13.1 cents of upside risk.

Q. WHAT ABOUT THE DOWNSIDE RISK?

A. The downside risk is the chance you take that the market price for power will drop below the contract price. However, the downside risk is limited by the short run marginal cost of producing power, which is driven largely by fuel cost. Absent predatory pricing, no generator can sell power for less than the short run cost of producing it.

Q. WHAT IS THE DOWNSIDE RISK FOR THIS CONTRACT?

A. When this contract was negotiated, the short run marginal cost of power produced by a combined cycle gas turbine was about 2.7 cents per kWh. That means the downside risk under this contract is about 3.2 cents per kWh. That is considerably less than the upside protection. In fact, the downside risk on a seven-year contract probably should be based on long run marginal cost, which would include amortization of a replacement unit. That would produce an even more favorable comparison.

Q. IS POWER MORE EXPENSIVE UNDER THIS CONTRACT THAN UNDER THE PREVIOUS AGREEMENT WITH APS?

A. Not compared with the experience of 2000-2001, but when normal periods are used for comparison, the cost of the new power component is about 1.7 cents per kWh higher, including provision for line losses. However, there are other important aspects of the new agreement.

Q. WHAT ARE THEY?

A. The Commission has articulated price stability as a ratemaking goal. This contract provides Citizens' customers with stability and predictability. If Arizona moves forward with retail electric competition, this contract will not create any new stranded costs if Citizens loses some customers. The contract is also relatively simple, with little chance of another dispute over terms. And finally, it has already saved a great deal of money in 2001.

Q. HOW MUCH HAS IT SAVED?

A. Last May, Citizens saw power prices spiking above 19 cents per kWh, similar to conditions in 2000. Based on that experience, Citizens estimated that the new contract may have saved as much as $70 million over the remaining summer months of June through September, 2001.

Q. SHOULD THE COMMISSION BE CONCERNED ABOUT THE PRUDENCE OF THE PREVIOUS CONTRACT?
A. I see no reason why it should. That contract was scrutinized and blessed repeatedly by most of the parties in this docket from 1995 to 2000.

Q. CAN YOU SUMMARIZE THE ATTENTION GIVEN TO THE CONTRACT DURING THOSE YEARS?
A. Yes. There were three regulatory proceedings which involved the contract from 1995 to 2000.

Q. WHAT WAS THE FIRST PROCEEDING?
A. The form of the contract that was in place in 2000-2001 emerged from contract negotiations between Citizens and APS that took place in early 1995. The chief revision to the contract was to increase the percentage of fixed cost pricing, which had the effect of lowering projected consumer costs through at least 1998. In September 1995, Citizens filed a general rate case which was litigated in 1996 and decided in December 1997.

Q. WAS THE CONTRACT AIRED IN THAT CASE?
A. Absolutely. There was a proposal made by the company to suspend the PPFAC adjuster. However, the consultants for the Commission staff and RUCO were so convinced that the revised contract would reduce costs that they insisted that the PPFAC be retained to capture the benefits of declining costs and the Commission agreed. (See Decision No. 59951, P. 40, L.8-24.)

Q. WHAT WAS THE NEXT PROCEEDING?
A. In July 1999, Citizens filed for a PPFAC adjustment which resulted in refunds to its customers, in December. Revised calculations in the administration of the contract were the cause of the refunds.

Q. WHAT WAS THE THIRD PROCEEDING?
A. The APS contract received its heaviest scrutiny in the litigation and settlement of Citizens' stranded cost proceeding, which concluded in the spring of 2000.

Q. WHY WAS THE CONTRACT SO IMPORTANT IN THAT PROCEEDING?

A. Stranded cost is a consequence of deregulating electric generation. Commission rules require a resolution of stranded cost before a utility has to open its service territory to retail competition. Stranded cost is a function of the value of a utility's generating assets in a deregulated market. Since Citizens has no power plants, its only generation asset is its wholesale contract with APS and that is its primary source of stranded cost.

Q. WERE THE CONTRACT TERMS THE SAME AS IN 1995?

A. Not exactly. In response to the stranded cost issue, Citizens had negotiated further amendments with APS. According to Citizens' filed testimony, the effects of the new amendments were to reduce generating costs by about 6 percent and liberalize the demand component of the contract, thereby lowering its stranded cost estimate from $47 to $18 million.

Q. WHAT WAS THE RESULT OF THE LITIGATION?

A. In June of 2000, RUCO, Commission staff and Citizens produced an agreement that was designed to settle the stranded cost issues and pave the way to retail electric competition in Citizens' service area. All parties to the agreement submitted supporting testimony.

Q. WHAT POSITIONS DID RUCO TAKE REGARDING THE CONTRACT?

A. Let me illustrate with selected portions of the testimony of RUCO's witness, Marylee Diaz Cortez. Referring to the settlement terms, she said:

"5. It allows Citizens to use the significant cost reductions that have been negotiated previously with APS with regard to the current purchased power contract to satisfy the requirements of R14-2-1604.C as a rate reduction for standard offer customers. (P. 2, L.17-20)

"8. It makes the need to divest the purchased power contract with APS much less likely." (P.3, L. 7-8)

Elsewhere, she stated, "... the newly re-negotiated purchased power contract with APS most likely will prove to be the lowest cost way of meeting the power requirements of Citizens' standard offer customers. Presumably, by now, the prices in the final version of the APS contract are reasonably close to expected wholesale market prices in the region. In fact, given the possible exercise of market power in the region, the prices in the re-negotiated APS contract might turn out to be lower than actual market prices." (P.5, L.10-16)

Q. WHAT WERE THE STAFF'S COMMENTS ABOUT THE CONTRACT?

A. I'll respond with portions of the testimony of the staff's consultant, Lee Smith: "Due to two renegotiations of its power supply contract with APS, stranded costs have been greatly reduced from the Company's initial filing. The company has already decreased its rates once to reflect the effect of the first renegotiation of its power supply contract with Arizona Public Service. Also, as noted in Provision 6 of the Settlement there has been a second renegotiation of the contract with APS that provides additional mitigation. After January 1, 2002 Citizens will be able to reduce its contract demand obligation to reflect lost load. This renegotiation may bring about a further power cost reduction which will be passed through to customers." (P.3, L.12-19)

In describing two provisions of the settlement, she said: "These provisions address the difficulties associated with divesting the APS contract and with acquiring Standard Offer generation through competitive purchase. It is expected that divesting the APS contract may increase stranded costs. With the revisions to the APS contract, it is unlikely that customers will be better off because of divestiture." (P.9,L.20-23)

Q. WHAT DOES THIS TESTIMONY SHOW?

A. This record shows conclusively that RUCO and the Commission staff were thoroughly familiar with the APS contract, that they understood its provisions, including the benefits and risks to Citizens' customers, and they endorsed the contract rather than requiring Citizens to divest it. The record also shows that staff and RUCO endorsed the PPFAC mechanism and fought to retain it.

Q. WHAT ABOUT THE DANGER OF HIGHER PRICES?

R. Clearly, these parties thought electric prices were headed downward or that they would remain stable. There was no expectation that prices would shoot out of sight and I think they weren't conditioned to guard against a huge upside risk. The timing of the settlement tells it all.

Q. WHAT DO YOU MEAN?

A. The supporting testimony was filed on June 20, 2000. By that time, electric bills were already headed through the roof in San Diego and electric loads were being shed in northern California. Yet, the staff and RUCO apparently thought it would be business as usual. Obviously, no one's crystal ball was working and the radar screens were blank.

Q. WHAT HAPPENED TO THE SETTLEMENT?

A. It was docketed for consideration by the Commission, but Citizens began getting its summer bills from APS. By September, the PPFAC was $54 million out of balance and the stranded cost settlement was put on hold.

Q. DO YOU HAVE ANY CONCLUDING REMARKS?

A. Yes. To date, Citizens has advanced more than $100 million to pay its customers' electric bills. It has earned no money on that investment and it has operated the Arizona Electric Division at a loss for almost two years. It is manifestly unfair to allow this matter to drag on and to allow Citizens' financial condition to deteriorate any further.

The key parties to this proceeding cannot seriously argue that Citizens' previous contract with APS was imprudent because they endorsed it repeatedly in earlier proceedings. Nor can they argue that the PPFAC was faulty. Their fingerprints are all over it. Unless the preponderance of the evidence proves that there was misfeasance in the administration of the contract, the Commission is legally and morally obligated to authorize Citizens to recover its lost revenues to date and its known future deficits under the amended power supply contract.

There is no way that Citizens can be made whole under any current ruling of the Commission. First, it's impossible to make up for lost carrying charges which may total $6 million before an order takes effect in this proceeding. Second, Citizens' formula cannot succeed in zeroing out the bank balance because too much time will have been lost by the time this matter is concluded. Finally, Citizens will be exposed to about 12 months of additional price risk because the APS contract will expire a year before the recovery period ends.

We are faced here with mopping up after an unexpected and extremely ugly turn of events. There is no fault or blame to be assigned. Electric customers all over the west shared the experience of consumers in Mohave and Santa Cruz counties in 2000 and 2001, except that in many cases it was more severe. The Commission should act quickly and fairly to provide Citizens with the tools it needs to dig out of a very deep financial hole.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.