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IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF THE UTILITY PROPERTY OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN

Docket No. E-01345A-08-0172

REPLY BRIEF OF FREEPORT-MCMORAN COPPER & GOLD INC. AND ARIZONANS FOR ELECTRIC CHOICE AND COMPETITION
(INTERIM RATES)

Freeport-McMoRan Copper & Gold Inc. and Arizonans for Electric Choice and Competition (hereafter collectively "AECC") hereby submit this Reply Brief in connection with the above-referenced matter. For reasons more fully described herein, AECC continues to support an interim rate increase for Arizona Public Service Company ("APS" or "Company") in the amount of $42.4 million, spread evenly among all customer classes subject to the increase, on an equal-percentage basis.

I. DISCUSSION

A. A $115 Million Increase In Interim Rates Exceeds What Is Necessary To Maintain An FFO/Debt Ratio And Credit Rating Above Non-Investment Grade.

1. *Some Interim Rate Relief is Warranted.*

AECC continues to support some level of interim rate relief for APS in order to avoid long-term financial harm to the Company's ratepayers. However, the primary difference between AECC and APS, the Arizona Investment Council ("AIC") and the

Mesquite Group[1] is over the level of increase required to keep APS' credit rating from falling into a non-investment grade rating. Because AIC and the Mesquite Group merely echo many of the same arguments contained in APS' post-hearing brief, AECC focuses primarily on the arguments presented by the Company on this issue.

For purposes of the analysis, AECC accepts the premise that an 18.0% FFO/Debt Ratio represents the minimum level required to prevent a credit ratings downgrade. (APS Post Hearing Brief ("APS Bf.") at p.15, ll. 22-26) Against this backdrop, AECC witness Kevin C. Higgins testified that a $42.4 million increase in interim rates, along with a cash infusion by Pinnacle West Capital Corporation ("PNW") in the amount of $400 million, would provide APS with a FFO/Debt Ratio of 18.25% by the end of 2009, which would be sufficient for the Company to maintain investment-grade credit ratings. (Tr. at p.269, ll. 17-23) Nothing in the record, or any of the parties' post-hearing briefs, suggest that Mr. Higgins' calculations in this regard are incorrect. Instead, APS provided evidence to demonstrate how Mr. Higgins' calculation is affected by the removal of the $400 million cash infusion. (APS Bf. at p.22)

By removing the $400 million cash infusion by PNW, APS attempts to demonstrate how Mr. Higgins' 18.25% FFO/Debt Ratio calculation falls to 16.4%, which would likely cause APS' credit rating to fall below investment grade. [APS Ex. 6] However, this calculation omits two very important factors: (1) the effect of a reduction of $500 million from the Company's capital expenditure program; and (2) the positive effect on the FFO/Debt Ratio caused by a $42.4 million interim rate increase recommended by Mr. Higgins. Mr. Higgins' calculations did not account for the $500 million reduction in APS' capital expenditure funds, which alone will have a positive effect on APS' FFO/Debt Ratio. *Id.* APS relies on two exhibits to support its contention that Mr.

[1] The "Mesquite Group" consists of Mesquite Power, LLC, Southwestern Power Group II, LLC and Bowie Power Station, LLC.

Higgins' proposed interim rate increase of $42.4 million is too low to support an FFO/Debt Ratio sufficient to keep APS' credit rating at investment grade.

APS Exhibit 6 illustrates that by the end of 2009, the Company's FFO/Debt Ratio will be 15.8% without the $400 million equity infusion. Taking into account the $500 million reduction in its capital expenditure plan, the FFO/Debt Ratio would rise to 16.4% *at present rates.* In APS Exhibit 9, APS' projected FFO/Debt Ratio by the end of 2009 would fall to 16.4% if Mr. Higgins proposed interim increase of $42.4 million was adopted, but the $400 million equity infusion is not made by PNW. What these two exhibits fail to show, however, is APS' projected FFO/Debt Ratio with **both** the $500 million reduction in capital expenditure **and** an interim increase of $42.4 million taken into account. Furthermore, APS witness Donald Brandt testified that PNW could make a $400 million equity infusion sometime in 2009, if market conditions allow it. (Tr. at p.391) This alone would increase the Company's FFO/Debt Ratio by approximately 2.0%. Indeed, financial markets may look to utility regulated rates of return as a safe investment vehicle over the next 12-18 months given the current weakness in the market today.

Still, if the $400 million equity infusion is not made, the $500 million reduction in capital expenditures for 2009, coupled with Mr. Higgins' proposed $42.4 million interim increase, would bring APS' FFO/Debt Ratio to about 18.76% by the end of 2009.

2. *Failing to Approve Any Interim Rate Increase Creates Undue Risk for APS Customers.*

Staff and the Residential Utility Consumer Office ("RUCO") recommend a denial of APS' requested interim rate increase, though Staff provides an alternative recommendation in the event the Commission is inclined to approve some level of interim rate relief. The threshold basis of Staff and RUCO's recommendation to deny any interim increase is that APS' request does not constitute an "emergency" that would justify the requested interim relief. [Staff Post Hearing Brief ("Staff Bf.") at p. 9; RUCO Post Hearing Brief ("RUCO Bf.") at p. 4-5] However, AECC asserts – as do several other parties in this proceeding – that there is no need to demonstrate that an "emergency" exists in order to grant interim rate relief. [AECC Post Hearing Brief ("AECC Bf.") at p.13-14; AIC Post Hearing Brief ("AIC Bf.") at p.7-9; Mesquite Group Post Hearing Brief ("Mesquite Bf.) at p.2-3; APS Bf. at p.5].[2]

Staff acknowledges that the Arizona Attorney General recognized in his 1971 opinion that the Commission's broad and exclusive power to choose modes by which it establishes rates "...should be construed broadly enough to permit the Commission to avail itself of concepts and procedures which are devised from time to time to permit effective utility regulation and to keep pace with constantly changing economic and social conditions." (Staff Bf. at p.8, ll. 21-25) RUCO makes no such admission, and instead supports a rigid regulatory paradigm that limits, rather than expands, "effective utility regulation." (RUCO Bf. at p.8-9)

Staff and RUCO cannot ignore the economic developments that have gripped the nation over the last several days. (AIC Bf. at p.2-4) Still, RUCO advises the Commission to focus on the fundamentals of setting rates "Regardless of whether APS' perceived threat of imminent downgrade is real or not..." (RUCO Bf. at p.5) This statement suggests that RUCO may not be concerned with whether APS loses its investment grade credit – which all parties concede would cost APS ratepayers in increased financing costs – so long as credit rating agencies are not allowed to influence the rate-setting process. This is a myopic view of utility regulation. The reality is that credit rating agencies do

[2] Arguments supporting interim rate relief are fully addressed in the post-hearing briefs filed by AECC, APS, AIC and the Mesquite Group. This portion of AECC's Reply Brief focuses on policy arguments advanced by Staff and RUCO in recommending a denial of any level of interim rate relief.

have an impact on how, and to what extent, utilities conduct business, which in turn affects utility ratepayers. (Mesquite Bf. at p.5-6) AECC does not suggest that a "threat" of an *imminent* downgrade is sufficient to grant interim rate relief. However, it should be an important factor to consider, and not simply ignored as RUCO suggests – especially with the current state of the financial markets today. *Id.*

Contrary to RUCO, Staff does provide the Commission with an alternative recommendation to grant APS interim rate relief in the amount of $65 million. In today's economic environment an argument could be made that an emergency may exist which may justify some interim rate relief." (Staff Bf. at p.36) Unfortunately in this scenario, the interim increase would be based on factors that AECC contends should be more fully addressed in the general rate case proceeding. Mr. Higgins' recommendation is based on the amount of revenue needed by the Company to keep its FFO/Debt Ratio above the 18% threshold and, thereby, avoid a credit downgrade in 2009. (Tr. at p.268, ln. 14 and p.269, ln. 10)

B. <u>Applying An Interim Rate Increase On An Equal-Percentage Basis Is Fair, Reasonable And In The Public Interest</u>.

Only one other party addressed the issue of rate design in its post-hearing brief – Commission Staff.[3] Staff correctly concludes that the issue of rate design is a public policy determination to be made by the Commission. However, AECC disagrees with Staff's general proposition that good public policy favors a rate spread that places a disproportionate amount of an interim rate increase (if so authorized) on higher load customers, without any evidence of cost causation in the record, so that smaller customers may benefit.

[3] Surprisingly RUCO, whose constituents stand to benefit from a per-kWh charge rate design if the Commission does grant some level of interim rate increase, apparently did not feel that the issue was important enough to address in its post-hearing brief.

1. *Fair and Equitable Rates for All Customer Classes Absent a Cost of Service Analysis.*

In its post-hearing brief, Staff postulates that "The general principle of rate design is normally used to fairly account for costs. The same principle for rate design for permanent rates cannot be applied to interim rates." (Staff Bf. at p.40, ll. 12-13) As a result, the Commission "must establish a fair and equitable way to distribute any interim rate increase deemed to be appropriate" in the absence of a record as to cost causation, which would be present in a permanent rate case. (*Id.* at ll.14-16) But then Staff concludes that a cents per-kWh charge is warranted not because it is fair and equitable, but because it tends to "benefit" smaller customers. (Tr. at p.620-621) While this may be true, the public policy question presented to the Commission is not what type of rate design will "benefit" smaller customers, but rather what kind of rate design is a **fair and equitable way to distribute** an interim increase in the absence of any evidence concerning cost causation.

What is equitable? Logic dictates that in its purest form, the determination of what is equitable involves some element of equal treatment. When setting permanent rates, the Commission uses this general principle in rate design to apportion base rate increases among different customer classes, based primarily on class cost of service studies. So, although the Commission is not afforded an opportunity to craft a rate design and apportion costs based on the evidentiary record in this proceeding, it may still adhere to the basic principles of fairness and equality by applying any interim increase that might be granted to APS on an equal percentage basis. AECC's recommended rate design is based on this traditional notion of fairness of equity, and will result in just and reasonable rates for all customer classes.

By contrast, Staff's recommended rate design is based on an analysis that supplants what is fair and equitable with a standard based on providing a benefit to those "least able" to pay for any rate increase. (Tr. p.650, ll. 1-3) Instead of looking at the overall effect that each rate design option will have on all customer classes, Staff focuses on their effect on residential customers and concludes that spreading an interim rate increase on a per-kWh basis is more fair and equitable because residential customers will bear a lower, albeit disproportionate, percentage of the increase. This unequal treatment among customer classes is acceptable to Staff because it has determined that residential customers are the least able to pay a rate increase, although Staff provided no evidence to support such a broad generalization. (Tr. at p.649, ln. 25 and p.650, ln. 5)

Conceptually, the idea that one class of customers would "benefit" from a particular rate design means there must be a corresponding "detriment" to another class, which would be the result for higher load customers if an interim increase is applied on a per-kWh basis. (*Id* at p.650, ll. 12-17) APS' E-3 and E-4 customers, which the Commission has already identified as those least able to pay, will be exempt from any rate increase that the Commission may approve – a rate design option that AECC supports as in the public interest. But now Staff is recommending that AECC members bear a greater proportion of any interim rate increase that might be approved for the benefit of residential ratepayers. This is best illustrated by APS Exhibit 18, which provides a bill comparison and effect on different customer classes of the rate design options available to the Commission.

According to APS Exhibit 18, Table 1, an interim increase applied on an equal percentage basis would result in a **4.36%** increase in base rates for all customer classes subject to the increase. However, when based on a per-kWh charge, the rate percentage increase for residential customers falls to **4.01%**, while it increases to **6.50%**[4] for large general service customers. This exhibit makes it clear that the per-kWh charge "benefits"

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[4] According to AECC witness Kevin Higgins, the upper limit increase for a 75% load factor customer is closer to 7.71%

residential customers to the "detriment" of larger customers. AECC asserts that such a rate design is unjust and unreasonable in the absence of any evidence to support the unequal treatment of different customer classes.

2. *All Customer Classes Will Bear Their Proportionate Share of Any Interim Rate Increase if Spread Evenly as an Equal Percentage Increase, and a Disproportionate Share if collected on a Per-kWh Charge.*

In support of its recommended rate design, Staff seems to advance the argument that higher load customers would not pay their proportionate share of an interim rate increase if the increase is spread evenly among all customer classes. This position is clearly not supported by the record. (Tr. at p. 1059; 1647; 647, ll. 17-19; and 996, ll. 17-20) Instead, Staff relies on two statements made by APS witness David Rumolo during his cross-examination. The first statement quoted by Staff is "under the cents per kWh basis it is the same charge for everyone, so if a particular class' consumption is 60 percent of the total, they would pay 60 percent of the charge." (Staff Bf. at p.41, ll. 5-6; Tr. at p.1037) The import of this statement, though incorrect, is that all customers will be paying their proportionate share under the per-kWh charge.

However, a closer examination of Mr. Rumolo's oral testimony demonstrates that he was referring to rate increases based on purchased power and fuel costs, because electricity is *consumed* by customers whereas infrastructure improvements are not. If the need for APS interim rate increase was the result of increased purchase power and fuel costs, then a per-kWh charge would be an appropriate basis for spreading the increase because cost causation can be directly linked to energy use. But this is not the case in this proceeding. Instead, the interim increase is driven by, among other things, a need to fund and recover for rate base items. Staff's own alternative recommendation to grant the Company a $65 million interim rate increase is consistent because the calculation is based upon a net change in APS' rate base, which includes plant additions, changes in accumulated depreciation, and several other items that comprise rate base. (Staff Bf. at p. 28, ll. 26-28) It is inappropriate to adopt a rate design based on energy use when the need for the interim rate increase involves rate base items.

Staff relies on another statement by Mr. Rumolo to suggest that higher load customers would pay a lower proportion of the overall increase under an equal percentage rate design: "…[o]n a percentage basis, the largest load factor customers would pay a lower proportion of the proposed $115 million. On a kilowatt hour charge, it would be directly proportional." (Staff Bf. at p.41, ll. 7-9; Tr. at p.1039) This statement is incorrect, and conflicts not only with the record, but with Mr. Rumolo's own affidavit filed on July 11, 2008, wherein he stated:

> Under the first rate option, the $0.003987/kWh would be applied to all affected customers. For un-metered customers, such as streetlighting sales, the charge would be based on the calculated energy consumption in the same manner as the Interim PSA Adjustor. Therefore, under this option customer would be paying the same as under the PAS and have no bill impact from what they are paying today. *However, for high load factor customers served from rates where energy-based charges are a large portion of the bill, an energy-based interim charge results in a greater increase than those customers would experience from a base rate increase that is not based solely on energy.* [emphasis added]

Affidavit of David J. Rumolo (July 11, 2008) [APS Ex. 18]. This statement clearly demonstrates that a per-kWh charge will result in a "greater increase" to higher load factor customers. Staff witness Ralph Smith addressed the issue of proportionality as follows:

> Q. But you would agree that an equal percentage across-the-board increase spreads the burden of an interim increase in a manner that is _*proportionate*_ to the current base rates, correct?
>
> A. That's what an equal percentage increase does. I would agree with that.

[emphasis added] (Tr. at p.652, ll. 5-10)

As the record demonstrates, there is no sound basis for allocating an interim increase based on energy usage. The cost recovery mechanism needs to reflect the general nature of the costs that are causing the need for an increase, and a flat per-kWh charge does not adhere to this fundamental rate design objective.[5] (Higgins Dt. at p.10)

VI. CONCLUSION

AECC concludes that some interim rate relief is warranted to protect retail customers from the negative consequences of a credit downgrade, but the amount of relief needed is significantly less than the amount requested by the Company. Specifically, AECC believes that it is appropriate to grant an interim rate increase, subject to refund with interest, sufficient to permit APS to attain a FFO/Debt Ratio of 18.25% in 2009. Mr. Higgins calculates that this ratio can be attained through an interim rate increase of $42.4 million on an annualized basis with the infusion of $400 million in equity. Although PNW now does not intend to make such an infusion, the infusion is more than replaced by the $500 million reduction in APS' capital expenditure plan. Therefore, AECC's recommendation is still applicable to permit APS to attain a FFO/Debt Ratio of approximately 18.25%. This incremental revenue should be recovered through an equal-percentage surcharge of no greater than 1.63% on the base rate portion of customer bills effective January 1, 2009, which can be reduced slightly by adjusting for 2009 load growth.

[5] Neither does the hybrid proposal presented by APS, which is apparently intended to be a compromise between a cost-recovery mechanism that is reasonable and one that it not. Although the hybrid approach produces customer impacts that are less unreasonable than the flat kWh charge, it is still "half wrong." Specifically, there is no basis in cost causation to allocate the interim increase to customer classes on an energy basis as would occur in the first step under this approach. Higgins Dt. at 10.

RESPECTFULLY SUBMITTED this 8th day of October 2008.

FENNEMORE CRAIG, P.C.

By [signature]
C. Webb Crockett
Patrick J. Black
3003 N. Central Avenue, Ste. 2600
Phoenix, AZ 85012-2913

Attorneys for Freeport-McMoRan Copper and Gold Inc. and Arizonans for Electric Choice and Competition

ORIGINAL and **13 COPIES** of the foregoing
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Docket Control
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona 85007

COPY of the foregoing was **HAND-DELIVERED/ MAILED/OR *E-MAILED** this 8th day of October 2008 to:

*Lyn Farmer
Chief Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007
lfarmer@azcc.gov

*Thomas Mumaw
Arizona Public Service Company
P.O. Box 53999
Phoenix, AZ 85072-3999
Thomas.Mumaw@pinnaclewest.com

-and-

*Deborah R. Scott
Pinnacle West Capital Corporation
400 North 5th Street
P.O. Box 53999, Ms 8695
Phoenix, AZ 85072-3999
Deb.Scott@pinnaclewest.com
Attorneys For Arizona Public Service Company

*Michael L. Kurtz

*Kurt J. Boehm
Boehm, Kurtz & Lowry
36 East Seventh Street, Suite 1510
Cincinnati, OH 45202
mkurtz@BKLlawfirm.com
kboehm@BKLlawfirm.com
Attorneys for The Kroger Company

*Lawrence V. Robertson, Jr.
Attorney at Law
P.O. Box 1448
Tubac, AZ 85646
tubaclawyer@aol.com
Attorney for Mesquite/SWPG/Bowie

*Michael A. Curtis
*William P. Sullivan
Curtis, Goodwin, Sullivan,
Udall & Schwab, P.L.C.
501 East Thomas Road
Phoenix, AZ 85012-3205
mcurtis401@aol.com
wsullivan@cgsuslaw.com
Attorneys for the Town of Wickenburg

*Timothy M. Hogan
Arizona Center for Law
in the Public Interest
202 East McDowell Road, Suite 153
Phoenix Arizona 85004
THOGAN@aclpi.org
Attorney for Western Resource Advocates
and Southwest Energy Efficiency Project

*Daniel W. Pozefsky, Chief Counsel
RUCO
1110 W. Washington St., Suite 220
Phoenix, AZ 85007
dpozefsky@azruco.com

*Michael M. Grant
Gallagher & Kennedy
2575 E. Camelback Road
Phoenix, AZ 85016-9225
MMG@gknet.com
Attorney for Arizona Investment Council

*Gary Yaquinto
Arizona Investment Council
2100 N. Central Ave., Suite 210
Phoenix, AZ 85004

gyaquinto@arizonaic.org

*Jay Moyes
*Karen E. Nally
Moyes Storey
1850 N. Central Ave., Suite 1100
Phoenix, AZ 85004-0001
jimoyes@lawms.com
kenally@lawms.com
Attorneys for AZ-AG Group

Jeffrey J. Woner
K. R. Saline & Assoc., P.L.C.
160 N. Pasadena, Suite 101
Mesa, AZ 85201
jjw@krsaline.com

Cynthia Zwick
1940 East Luke Avenue
Phoenix, Arizona 85016
czwick@azcaa.org

*Janice Alward, Chief Counsel
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007-2927
JAlward@azcc.gov

*Janet Wagner
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007-2927
JWagner@azcc.gov

*Maureen Scott
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007-2927
mscott@azcc.gov

*Ernest G. Johnson, Director
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007-2927
EJohnson@azcc.gov

By: Mary Bollington

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