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May 20, 2010

Arizona Corporation Commission
DOCKETED
MAY 20 2010
DOCKETED BY

Kristin K. Mayes, Chairman
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Re: April 30, 2010 letter regarding Arizona Public Service Company's Power Supply Adjustor, Docket No. E-01345A-08-0172

Dear Chairman Mayes:

This letter responds to your request that Arizona Public Service Company ("APS" or "Company") provide the Arizona Corporation Commission ("Commission") with APS's current projections for its monthly Power Supply Adjustor ("PSA") balance for 2010, as well as a plan for the treatment of any credit balance remaining in the PSA account after the summer season. With respect to your first request, APS is providing the most recent monthly PSA balance forecast given to Commission Staff, which is confidential, to each of the Commissioners under seal.

With respect to your second inquiry, APS believes that the PSA should continue to operate as it was intended through the summer and that the Commission, if it still has concerns, should revisit this issue in the fall. This is appropriate because:

- $73 million of the $102 million PSA credit balance cited is already being refunded to customers through January 2011 through the Historical Component of the PSA.

- As to the portion of the credit balance that is not now being refunded, current forecasts show that APS will have an "over-collection" of only approximately $6 million at the end of the summer – a number that can easily fall and become negative if the summer is hotter than anticipated or if an unexpectedly bad hurricane season causes natural gas prices to rise.

- If any potential credit balance in the PSA is totally refunded this year, the PSA rate for next year will be higher. This increase, as well as expected future increases in other adjustor surcharges, will be moderated if the PSA is permitted to work as designed and

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the refund of any new credit balance is synchronized with the expiration of last year's refund in February of 2011.

- The Company's forward-looking PSA has been recognized by credit rating agencies as a positive regulatory tool that is critical to the Company's financial health. S&P has said, for example, that "the primary benefit of the outcome of [APS's rate case resolved in 2007] is that it provides the utility with a much stronger PSA," that is "from a credit perspective vital to preserving investment-grade credit quality."[1] Attempts to modify the PSA's normal process may be viewed negatively in light of the uncertainty that always surrounds fuel and purchased power prices.

Some background into the design of the PSA may be useful in elaborating on these points and assessing whether a refund of any post-summer PSA credit balance should be accelerated. As you know, the PSA is comprised primarily of two components: (1) a Forward Component, which recovers dollars based on a forecast of the current year's fuel costs; and (2) a Historical Component, which operates in part as a true-up to the prior year's PSA balance, collecting or refunding dollars as appropriate to reconcile projected costs with actual costs.[2] Pursuant to the Plan of Administration, these accounts are automatically reset in February of each year, setting the Forward Component to the new projected fuel rate and moving the residual balance of that account (positive or negative) from the previous year to the Historical Component.

The Forward Component and Historical Component serve two distinct purposes and must be separately considered when determining whether the variance between APS's anticipated and actual fuel costs is sufficiently large to warrant a mid-year change to the PSA rate. In your letter, you note that a recent APS monthly PSA balance projection had reflected an "over-collection balance of $102 million." Of that number, however, $73 million was the then-current balance of the Historical Component, which is already being refunded to customers each month through January 2011. This refund helps moderate the customer bill impact of APS's recent rate increase, and the APS rate case settlement anticipated that this moderating impact would continue until February 2011. Of the $102 million cited, only $29 million reflects an over-collection in the Forward Component and is not yet being returned to customers.

An over-collection in the spring of a sum such as $29 million is not unusual. In fact, the PSA was designed to have a credit balance in the Forward Component at this time of year. During the hot summer season, customers use more electricity and fuel costs go up – a combination that results in higher customer bills in June through September. In order to moderate that summer bill impact, the PSA rate is structured to collect more dollars than APS would likely need during the early part of the year so that customers would pay a lower rate than they otherwise would during the summer, when bills are at their highest. As you indicate in your letter, the credit balance generated during the spring

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1 *See* S&P Arizona Public Service Co. Analysis, July 11, 2007.

2 Although a third "Transition Component" is available to allow a mid-year change to the accounts, the Plan of Administration advises that it should be used only when "variances between the anticipated recovery of fuel and purchased power costs . . . under the combination of base rates and the Forward Component become so large as to warrant recovery, should the Commission deem such an adjustment to be appropriate."

is drawn down over the summer. This year, the $29 million credit balance projected for the Forward Component in February 2010 is expected to fall to $6 million by September 2010 – a forecast that is highly dependent upon assumptions about such conditions as summer temperatures, the severity of the hurricane season, and other variables that impact fuel costs and electricity sales. In recent years, variations from fuel cost projections have been in the range of roughly $15 million (plus or minus), not including any Hurricane Katrina-like events that would substantially increase the cost of gas and easily turn that $6 million credit balance into a deficit.[3] Given the likelihood that the $6 million projected balance will change during the course of the summer, APS believes that any evaluation of whether an early refund should occur should wait until early fall. At that time, the Commission and the Company will be better positioned to assess whether the then-existing balance merits an early reset.

Whenever this evaluation is made, an important consideration will be whether the customer benefit of an early reset truly outweighs its ultimate bill-impact consequences. When the refund of last year's credit balance and interest payments on that balance expire in January 2011, customer bills will naturally rise. If the PSA operates as designed, the refund (with interest) of any new credit balance will begin at the same time that last year's refund terminates. This synchronization will continue to offset the impact of the Company's settlement rate increase, which the Commission and settling parties viewed as an important benefit of the Settlement Agreement. Moreover, the PSA reset in February will occur at about the same time of year that the balances of the Company's other adjustment mechanisms change. To whatever extent APS owes a refund in February through the PSA, a reset at that time can be used to offset expected increases in those other adjustor balances as well.

Finally, you asked about the interest that APS earns on the PSA credit balance. APS does not earn interest on the PSA credit balance. To the contrary, the PSA Plan of Administration requires that APS *pay* 0.45% interest in 2010 on any credit balance that exists throughout the year. In addition, having a credit balance in the PSA has not generally provided APS with a cash surplus on which it might earn interest. Any temporary cash balance APS has maintained is conservatively invested in highly liquid and safe investments that typically bear low interest returns (currently in the 0.03% to 0.4% range).

We hope this letter addresses your inquiries. Please feel free to contact me should you have any additional questions.

Sincerely,

Meghan H. Grabel

Meghan H. Grabel

cc: Commissioner Gary Pierce
Commissioner Paul Newman

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3 It certainly has been more typical for the PSA to be under-collected than over-collected. Before 2007, the PSA balance had been under-collected by upwards of $160 million and $170 million in some years.

Commissioner Sandra Kennedy
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