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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

GARY PIERCE - Chairman
BOB STUMP
SANDRA D. KENNEDY
PAUL NEWMAN
BRENDA BURNS

IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR AUTHORIZATION FOR THE PURCHASE OF GENERATING ASSETS FROM SOUTHERN CALIFORNIA EDISON AND FOR AN ACCOUNTING ORDER.	**DOCKET NO. E-01345A-10-0474** **STAFF'S CLOSING BRIEF**

I. INTRODUCTION.

In Decision No. 67744, the Arizona Corporation Commission ("Commission") imposed a moratorium on the acquisition of an interest in any utility generating unit by Arizona Public Service Company ("APS" or "Company") prior to January 1, 2015.[1] In its application, APS is requesting that the Commission waive that moratorium so that APS can pursue the acquisition of Southern California Edison Company's ("SCE") interest in Units 4 and 5 of the Four Corners Power Plant ("Four Corners").[2] APS is also requesting an accounting order that will: 1) authorize the Company to defer for future recovery certain costs relating to the transaction; and 2) provide assurance that APS may continue to recover the capital carrying costs, depreciation, decommissioning, mine reclamation, and other obligations that may arise with respect to Four Corners Units 1 – 3.[3]

The Utilities Division ("Staff") for the Arizona Corporation Commission recommends that the Commission waive the moratorium contained in Decision No. 67744 to allow APS to acquire SCE's interest in Four Corners Units 4 and 5, if APS so desires.[4] However, Staff is not recommending that the Commission approve the acquisition itself, nor is Staff making any recommendation regarding

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[1] Decision No. 67744 (April 7, 2005), Finding of Fact ¶ 33, Attachment A, ¶ 74.
[2] Application at 4.
[3] *Id.* at 4.
[4] Exh. S-2, Furrey Direct at 4.

whether APS should purchase SCE's interest in Units 4 and 5.[5]

Staff further recommends that the Commission approve an accounting order with the provisions discussed more fully in Section III, *infra*.

II. STAFF RECOMMENDS THAT THE COMMISSION WAIVE THE MORATORIUM IMPOSED IN DECISION NO. 67744.

The moratorium imposed by Decision No. 67744 requires APS to address the following five criteria as part of any APS request for Commission authorization to acquire an interest in a utility generating unit prior to January 1, 2015:[6]

a. The Company's specific unmet needs for additional long-term resources.

b. The Company's efforts to secure adequate and reasonably-priced long-term resources from the competitive wholesale market to meet those needs.

c. The reasons why APS believes those efforts have been unsuccessful, either in whole or in part.

d. The extent to which the request to self-build generation is consistent with any applicable Company resource plans and competitive resource acquisition rules or orders resulting from the workshop/rulemaking proceeding described in paragraph 79.

e. The anticipated life-cycle cost of the proposed self-build option in comparison with suitable alternatives available from the competitive market for a comparable period of time.[7]

Staff believes that the evidence introduced during the hearing in this matter demonstrates that APS has adequately addressed the five criteria set forth in Decision No. 67744. Accordingly, Staff recommends that the Commission waive the moratorium imposed by Decision No. 67744.

A. <u>Staff Believes APS Has Adequately Addressed Its Specific Unmet Needs For Additional Long-Term Resources.</u>

Staff believes APS has adequately addressed its specific unmet needs for additional long-term resources. Even if the proposed transaction is consummated, APS represents that it will require

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[5] Tr. Vol. V at 1037-1038.

[6] Decision No. 67744 (April 7, 2005).

[7] *Id.* at Attachment A, ¶ 75.

another 545 MW of resources to meet its 2017 load requirements.[8] If the proposed transaction is not consummated, APS represents that its need for new resources could increase to over 1,500 MWs in 2017.[9] APS expects the proposed transaction to result in a net increase of 179 MW of baseload capacity which APS believes will provide protection against volatile natural gas prices as well as the potential loss of the Navajo Generating Station capacity.[10]

B. <u>Staff Believes APS Has Adequately Addressed Its Efforts To Secure Adequate And Reasonably-Priced Long-Term Resources From The Competitive Wholesale Market To Meet Those Needs And The Reasons Why APS Believes Those Efforts Have Been Unsuccessful, Either In Whole Or In Part.</u>

Staff believes APS has adequately addressed its efforts to secure adequate and reasonably-priced long-term resources from the competitive wholesale market to meet APS' resource needs and explained why those efforts have been unsuccessful. While APS acknowledges a variety of possible baseload generation resources as replacement options for baseload capacity, none of these resources were found to be suitable alternatives to the baseload capacity provided by Four Corners.[11] Specifically, APS notes that there is no existing market for a coal or nuclear resource that would be available to replace Four Corners generation on the necessary timeline.[12] In addition, APS notes that a natural gas resource is not a suitable alternative to the proposed transaction because it is more costly[13] and would increase APS customer exposure to natural gas price volatility by decreasing resource diversity.[14]

The Arizona Competitive Power Alliance ("ACPA") suggests that APS could not have adequately addressed its efforts to secure adequate and reasonably-priced long-term resources from the competitive wholesale market because APS failed to issue a request for proposals ("RFP") in the competitive wholesale market to replace the energy capacity lost if Units 4 and 5 were retired. However, ACPA's suggestion is wrong for several reasons.

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[8] Exh. APS-8, Dinkel Direct at 12.
[9] *Id.*
[10] *Id.*
[11] *Id.* at 3-4.
[12] *Id.* at 4, 13.
[13] Exh. APS-10, Rose Rebuttal at 23.
[14] Exh. APS-8, Dinkel Direct at 10, 13.

First, an RFP is not required under the Resource Planning and Procurement Rules.[15] Therefore, APS should not be expected to address the results of an RFP as part of APS' efforts to secure adequate and reasonably-priced long-term resources from the competitive wholesale market.

Second, APS has shown that an RFP is neither advisable in this instance nor likely to result in bids that compete with the savings that would result from the proposed transaction. For example, APS witness Pat Dinkel testified that an RFP is not advisable because stalling the proposed transaction for the purpose of issuing an RFP would send adverse signals to SCE, the California Public Utilities Commission ("CPUC"), and BHP Billiton which may jeopardize important elements associated with the proposed transaction.[16]

In addition, APS witness Judah Rose testified that the chance of APS procuring power through an RFP that is a better value to customers compared to the proposed transaction is "practically nil."[17] Mr. Rose explained that recent bids in Arizona from existing combined cycle facilities varied from approximately $533 per kW, $600 per kW, and $900 per kW.[18] Mr. Rose opined that there has "never been a price as low as required to beat [the proposed transaction]."[19]

Staff notes that while ACPA criticizes APS for failing to conduct an RFP, ACPA has failed to introduce any evidence whatsoever as to the value of any bids APS might expect were it to issue an RFP. In this regard, ACPA has failed to rebut the evidence proffered by APS. Staff does not believe the Commission should require APS to issue an RFP in this instance.

C. **Staff Believes APS Has Adequately Addressed How The Proposed Transaction Is Consistent With APS' Applicable Resource Plan.**

Staff believes APS has adequately addressed how the proposed transaction is consistent with APS' current Resource Plan on file with the Commission. APS represents that the goal of its resource plan is to maintain a balanced and diverse energy supply portfolio.[20] If the proposed transaction is not consummated, APS expects that its reliance on natural gas as a percentage of its

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[15] *See* A.A.C. R14-2-705(B). *See also* Section II.D., *infra*.
[16] Tr. Vol. III at 392 - 393.
[17] Tr. Vol. II at 226.
[18] *Id.* at 173-174.
[19] *Id.* at 172-173.
[20] Application at 26-27.

energy supply portfolio would increase from 25% to 40% while its reliance on coal would decrease from 39% to 14%.[21] APS witness Pat Dinkel testified that tipping APS' energy supply portfolio balance in favor of natural gas at the expense of coal would place APS' customers in "far too great of a risk."[22] Accordingly, Staff believes that the proposed transaction is consistent with APS' current Resource Plan because it helps to maintain a balanced energy supply portfolio.

In addition to resource diversity, Staff also believes that the proposed transaction is consistent with the other key elements of APS' current Resource Plan, namely financial sustainability, resource self-sufficiency, long-term planning for resource needs, and the need for flexibility.[23]

D. Staff Believes APS Has Adequately Addressed How The Proposed Transaction Is Consistent With Competitive Procurement Resource Acquisition Rules.

Decision No. 67744 ordered Staff to schedule workshops on resource planning issues.[24] These workshops resulted in the Commission's Recommended Best Practices for Procurement in Decision No. 70032[25] which was later incorporated into the amendments to the Resource Planning and Procurement Rules that are codified in Title 14, Chapter 2, Article 7 of the Arizona Administrative Code ("A.A.C.").[26]

Under both the Recommended Best Practices for Procurement and the Resource Planning and Procurement Rules, a load serving entity may use a number of procurement methods for the wholesale acquisition of energy and capacity, including by bilateral contract with a non-affiliated entity, such as the proposed transaction between APS and SCE.[27] However, these practice and procurement rules require load-serving entities to use an RFP process as its primary acquisition process for the wholesale acquisition of energy and capacity unless one of a number of listed exceptions applies.[28] One such exception allows a utility to forego the RFP process if "[t]he

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[21] Exh. APS-8, Dinkel Direct at 11.
[22] Tr. Vol. III at 502.
[23] Exh. S-2, Furrey Direct at 10-15.
[24] Decision No. 67744 (April 7, 2005), Attachment A, ¶79.
[25] Decision No. 70032 (December 4, 2007).
[26] Tr. Vol. V at 1025.
[27] A.A.C. R14-2-705(A); *see also* Decision No. 70032, Finding of Fact ¶5.
[28] *See* A.A.C. R14-2-705(B) ("A load-serving entity shall use an RFP process as its primary acquisition process for the wholesale acquisition of energy and capacity, unless one of the

transaction presents a genuine, unanticipated opportunity to acquire a power supply resource at a clear and significant discount, compared to the cost of acquiring new generating facilities, and will provide unique value to the load-serving entity's customers."[29] Staff believes that the proposed transaction meets this exception.

1. Staff believes that the proposed transaction represents a genuine, unanticipated opportunity to acquire a power supply resource.

California Senate Bill ("SB") 1368, enacted on September 29, 2006, mandated that greenhouse gas ("GHG") emissions rates for baseload generation sources must be no higher than the GHG emissions rate of a combined-cycle gas turbine power plant and directed the CPUC to establish an emissions performance standard ("EPS") to enforce that objective.[30] On January 25, 2007, the CPUC issued Decision 07-01-039 which established an EPS that, in part, precluded California load serving entities from making any "long-term financial commitments"[31] in baseload fossil-fueled power plants such as Four Corners.[32]

On January 28, 2008, SCE petitioned the CPUC for a modification of Decision No. 07-01-039 to exempt Four Corners from the requirements of the EPS.[33] On October 14, 2010, the CPUC issued Decision No. 10-10-016 denying SCE's request for an exemption from the EPS for Four Corners and denying recovery in rates of capital expenditures for Units 4 and 5 to be incurred beginning January 1, 2012 and beyond.[34]

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following exceptions applies:") *and* Decision No. 70032, Finding of Fact ¶5 ("Utilities should seek to use an RFP as the primary acquisition process. Exceptions may include the following:").

[29] A.A.C. R14-2-705(B)(5); *see also* Decision No. 70032, Finding of Fact ¶5 (utilities are not required to use an RFP process "[w]hen the utility encounters a genuine, unanticipated opportunity to acquire a power supply resource at a clear and significant discount when compared with the cost of acquiring new generating facilities that will provide unique value to customers").

[30] California SB 1368 (September 29, 2006), section 2.

[31] *See* CPUC Decision No. 10-10-016 at pages 5-6 ("long-term financial commitment" includes any load serving entity investment in retained generation that "is intended to extend the life of one or more units of an existing baseload powerplant for five years or more, or results in a new increase in the existing rated capacity of the powerplant").

[32] CPUC Decision No. 10-10-016 at 5.

[33] *Id.* at 7.

[34] *Id.* at 30.

On December 15, 2009, SCE sent a letter notifying the other co-owners of Units 4 and 5 that SCE could no longer maintain its interest in Units 4 and 5 beyond 2016[35] and offering the other co-owners the opportunity to purchase that interest.[36] APS witness Mark Schiavoni testified that December 15, 2009 was when APS first learned that SCE intended to sell its interest in Units 4 and 5.[37] Mr. Schiavoni further testified that APS began negotiations with SCE for the purchase of SCE's interest in Units 4 and 5 in January of 2010[38] and worked expeditiously to enter into an agreement with SCE by November of 2010 to acquire that interest.[39]

Staff believes that the timing of the proposed transaction represents a genuine, unanticipated opportunity for APS because APS had no control over the factors that influenced and precipitated SCE's offer to sell its interest in Units 4 and 5. Specifically, APS had no control over when SCE would sell its interest in Units 4 and 5, if at all, and to whom. In addition, APS had no control over whether the CPUC exempted Four Corners from the California EPS. Although SB 1368 was enacted in 2006, uncertainty regarding its impact on Four Corners prevailed until the CPUC rejected SCE's request for an exemption on October 14, 2010. Until that decision was issued, it was at least possible that SCE could have maintained its interest in Units 4 and 5 beyond 2016.

ACPA appears to suggest that the proposed transaction was anticipated because APS was aware that California enacted SB 1368 in 2006. However, this suggestion ignores the fact that APS did not learn of SCE's intentions with respect to Four Corners until December of 2009.[40] Moreover, any suggestion that APS knew SCE had no choice but to sell its interest in Units 4 and 5 is belied by the fact that the CPUC did not definitively reject SCE's request for an exemption from the EPS for Four Corners until October 14, 2010.

2. Staff believes that the power supply resource is being offered at a clear and significant discount when compared to the cost of acquiring new generating facilities.

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[35] Tr. Vol. II at 310.
[36] *Id.* at 288.
[37] *Id.* at 343.
[38] *Id.* at 345.
[39] *Id.* at 346.
[40] *Id.* at 343.

Staff believes that SCE's interest in Units 4 and 5 is being offered at a clear and significant discount when compared to the cost of acquiring new generating facilities.[41] Specifically, the evidence shows that the proposed transaction is lower than the cost of acquiring new generating facilities in terms of: 1) the capital cost of the resource itself; 2) the levelized cost for the resource over the life of the investment; and 3) the resource's total impact on system-wide revenue requirements over the life of the investment.

From a capital cost standpoint, APS estimates that the capital costs associated with the purchase of SCE's interest in Units 4 and 5 total approximately $626 million[42] or about $847 per kW.[43] On the other hand, APS estimates that the cost of constructing new combined-cycle natural gas facilities is a much more expensive alternative to the proposed transaction at a total capital cost of approximately $680 million, or $1,253 per kW.[44] Once transmission costs are taken into account, APS further estimates that the total cost of constructing new natural gas facilities rises to approximately $798 million, or $1,357 per kW.[45]

From a levelized cost standpoint, APS projects that the proposed transaction will cost approximately $85 per kW over the life of the plant.[46] In the alternative, APS estimates that the cost of constructing new combined-cycle natural gas facilities with new transmission would be much higher at a cost of approximately $100 per kW over the life of the investment.[47]

From a revenue requirement impact standpoint, APS estimates that the proposed transaction results in a system-wide revenue requirement that has a net present value that is $488 million less than the cost of replacing APS' interest in Four Corners Units 1 – 5 with new combined-cycle natural gas facilities.[48]

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[41] APS believes that a combined-cycle natural gas facility is the most viable baseload generation alternative to the proposed transaction given the length of time needed to construct a new coal or nuclear facility and the intermittency or capacity limitations associated with renewable energy resources. Exh. APS-8, Dinkel at 4.

[42] Exh. S-2, Furrey Direct at 18.

[43] Exh. APS-8, Dinkel Direct at 5.

[44] *Id.*

[45] Exh. S-2, Furrey Direct at 9.

[46] Exh. APS-8, Dinkel Direct at 6.

[47] *Id.*

[48] *Id.* at 7.

3. Staff believes that the proposed transaction will provide unique value to APS' customers.

Staff believes that the proposed transaction will provide unique value to APS' customers for multiple reasons. First, as noted above, the proposed transaction is projected by APS to result in a system-wide revenue requirement that has a net present value that is $488 million less than the cost of replacing Four Corners Units 1 – 5 with new combined-cycle natural gas facilities and $1.08 billion less than the cost of investing in the environmental upgrades to keep Units 1 – 3 operational.[49]

Second, APS has shown that the proposed transaction provides additional value to customers because the price of coal as a fuel source is less volatile than natural gas. As stated earlier, if the generation at Four Corners is replaced by natural gas generation, APS' reliance on natural gas as a percentage of its energy supply portfolio will increase from 25% to 40%.[50] Staff believes the proposed transaction will help minimize the risk to APS customers caused by over-reliance on a single generation resource.

Third, APS has shown that the proposed transaction will have the smallest impact on customer bills.[51] If the proposed transaction moves forward, APS estimates that customer bills would increase by almost 4 percent by 2017 (7 percent if a carbon tax of $20/ton is imposed).[52] In the alternative, if Units 4 and 5 are retired and APS invests in the environmental upgrades to keep Units 1-3 operational, APS estimates that customer bills would increase by almost 7 percent by 2017 (9 percent if a carbon tax of $20/ton is imposed).[53] Moreover, if Units 1 – 5 are retired and replaced with new combined-cycle natural gas generation, APS estimates that customer bills would increase by approximately 8 percent by 2017.[54]

E. <u>Staff Believes APS Has Adequately Addressed The Anticipated Life-Cycle Cost Of The Proposed Option In Comparison With Suitable Alternatives Available From The Competitive Market For A Comparable Period Of Time.</u>

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[49] *Id.*
[50] *Id.* at 11.
[51] Exh. APS-14 Guldner Direct at 4; Exh. S-2 Furrey Direct at 22.
[52] *Id.*
[53] *Id.*
[54] *Id.*

Staff believes APS has adequately addressed how the levelized life-cycle cost of the proposed transaction compares with suitable alternatives available from the competitive market for a comparable period of time. Specifically, APS has shown that the levelized life-cycle cost of the proposed transaction is lower than any expected offerings from suitable alternatives from the competitive market. Based on recent APS solicitations with merchant gas generators in the competitive market, APS estimates the cost of existing natural gas generation to be $750 per kW, which produces a levelized life-cycle cost of about $91 per MWh, inclusive of transmission costs.[55] APS estimates the cost of constructing new natural gas generation to be $1,357 per kW, inclusive of transmission costs, which produces a levelized life-cycle cost of about $100 per MWh.[56] At a levelized life-cycle cost of $85 per MWh, the proposed transaction is less costly than replacing Four Corners with new or existing natural gas generation.

III. APS' REQUEST FOR AN ACCOUNTING ORDER.

In addition to seeking authorization to pursue the acquisition of SCE's share of Units 4 and 5 of Four Corners, APS seeks an accounting order that will authorize the Company to defer for future recovery certain costs relating to the transaction, and provide assurance that APS may continue to recover the capital carrying costs, depreciation, decommissioning, mine reclamation, and other obligations that may arise with respect to Units 1 – 3.[57] An accounting order is a rate-making mechanism for use by regulatory authorities that provides regulated utilities, in this case APS, with the ability to defer costs that would otherwise be expensed using generally accepted accounting principles and further provides for alternative rate-making treatment of capital costs and other costs via creation of regulatory assets and liabilities.[58] Without authorization for such a mechanism, APS would have to expense any costs associated with this transaction in the period they were incurred.[59]

A. <u>The Circumstances in this Case Warrant the Commission Authorizing an Accounting order for APS.</u>

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[55] Exh. APS-13, Dinkel Rebuttal at 4.
[56] Exh. APS-8, Dinkel Direct at 5-6.
[57] Application at 23.
[58] Exh. S-3, Michlik Direct at 3.
[59] *Id.*

It is APS' contention that the authorization of an accounting order in this case will address the timing mismatch between costs and benefits that occurs from when the proposed transaction closes to when APS is actually able to recover the asset in rates.[60] In particular, APS asserts that its customers will see substantial long-term savings if the proposed transaction is approved, while APS will have to absorb significant short terms costs absent a deferral.[61] In conjunction with the transaction, APS will face increased operating expenses associated with the additional ownership, will assume certain of SCE's assets and liabilities which APS would record at fair value at the time of the acquisition.[62] APS estimates that these new costs would be approximately $70 million per year.[63] APS believes that an inequity will result due to its PSA.[64] Under the PSA mechanism, its customers will immediately benefit from the fuel savings that will result from the proposed transaction but will not be required to pay for the investment until it is ultimately placed in rate base at the conclusion of the Company's rate case using a test year when SCE's share is purchased.[65] In addition, APS indicates that the accounting order must also include language that provides for the future recovery of costs associated with the closure of Units 1 – 3 in order to avoid the potential for immediate write-off of all or a portion of those costs upon closure.[66] APS makes it very clear in its request that the deferral would not increase customer bills today, and would simply provide APS with a mechanism to ensure future recovery of the costs related to the acquisition and mitigate the impact of the transaction on the Company's financial condition.[67] APS cites to six prior decisions where the Commission has authorized APS to defer certain costs.[68]

Staff analyzed APS' request for authorization of an accounting order using three fundamental criteria:[69]

1. Would APS incur irreparable economic harm absent an accounting order?[70]

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[60] Exh. APS-14, Guldner Direct at 9.
[61] *Id.* at 8.
[62] *Id.*
[63] *Id.*
[64] *Id.*.
[65] *Id.*
[66] *Id.* at 11.
[67] *Id.* at 10.
[68] *Id.* at 10-11.
[69]Exh. S-3, Michlik Direct at 5.

2. Would APS endure a significant inequity absent an accounting order?[71]

3. What are the relative costs and benefits to ratepayers resulting from granting an accounting order?

In applying these criteria to APS' request, it is Staff's belief that this is both a qualitative as well a quantitative evaluation, and that ultimately the authorization of an accounting order is a variance from normal ratemaking.[72]

Although Staff does not believe that absent an accounting order that APS would incur irreparable economic harm, the impact would nonetheless be significant.[73] In response to a data request the Company stated that denial of the accounting order, among other effects would cause APS' return on equity to decline by 1% – a significant reduction compared to the 9% return on equity APS states it earned during the 12 months ended September 30, 2010.[74]

Furthermore, Staff believes that the proposed transaction does present some potential inequities to APS.[75] However, the timing mismatch raised by APS by itself is not sufficient to warrant an accounting order. Specifically, Staff does not believe that the mere fact that APS will incur expenses associated with this transaction that will be lost absent an accounting order is a sufficient basis for authorizing an accounting order. Lost opportunities are a recognized and normal part of the regulatory framework.[76] Utilities regularly make plant investments and incur incremental costs between rate cases.[77] The regulatory frame work assumes that these costs are offset by other regulatory benefits such as customer growth, depreciation expense, and operating efficiencies.[78] The mere existence of the lost opportunities for recovery of these costs does not warrant authorization of an accounting order.[79] However, the cumulative effect of various factors such as the magnitude of

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[70] *Id.*
[71] *Id.*
[72] *Id.*
[73] *Id.* at 6.
[74] *Id.*
[75] *Id.*
[76] *Id* at 7.
[77] *Id.* at 7.
[78] *Id.* at 7.
[79] *Id.*

the loss, timing of remedy, and impact on the utility and its ratepayers can cause inequitable circumstances that warrant deviation from the normal regulatory framework.[80]

In this case while the absence of an accounting order, in Staff's opinion, will not cause irreparable financial harm, it will be significant.[81] Further, APS continues to receive the minimum investment grade debt ratings, and APS and its ratepayers will benefit by maintaining or increasing its debt rating.[82] Although Staff does not believe that APS' current debt rating is in jeopardy, the consequence of a downgrade is potentially more costly than deviating from typical ratemaking and authorizing an accounting order.

The timing of this transaction is also unfavorable for APS. According to APS the target closing date for this transaction is October 1, 2012, which is three months after APS anticipates the Commission will authorize rates for its currently pending rate applications. In other words, APS does not believe it will be able to include its increased ownership in rates, if this application is approved, until July 1, 2014. The timing of this transaction also supports the authorization of an accounting order.[83]

Finally, the existence of the PSA provides additional support for the authorization of an accounting order.[84] Although the PSA includes a 90/10 sharing mechanism under which APS absorbs 10 percent of increases over the amount included in base rates and collects 10 percent of decreases from the amount included in base rates from ratepayers, the mere existence of this sharing is not the basis for Staff recommending an accounting order. Four Corners Units 4 and 5 are more fuel efficient than Units 1 – 3. As a result, if APS acquires SCE's share of Units 4 and 5, this transaction will reduce fuel costs, most of which will inure to the benefit of the ratepayers. In other words, APS would absorb the incremental cost of the transaction while ratepayers receive the majority of the benefits.[85]

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[80] *Id.*
[81] *Id.* at 8.
[82] *Id.*
[83] *Id.*
[84] *Id.* at 9.
[85] *Id.* at 9.

None of these issues individually warrant authorizing an accounting order. However, since all of these issues exist in this case, Staff recommends approval of APS' request for an accounting order. However, as addressed below, the scope of the accounting order should be more limited than what APS is requesting.

Staff notes that RUCO was the only other party in this case that addressed the Company's request for an accounting order. Initially, RUCO opposed the Company's request for an accounting order, but indicated that if the Commission was to authorize and accounting order it should include conditions similar to those adopted in Decision No. 67504.[86] However, during the hearing RUCO modified its position, and it now recommends approval of an accounting order where necessary and beneficial.[87]

B. <u>The Scope of the Accounting Order Should Only Include the Additional Non-fuel Costs of Owning, Operating and Maintaining the Acquired Interest in Units 4 and 5.</u>

APS initially requested the following accounting order language:

> IT IS THEREFORE ORDERED that Arizona Public Service Company's request for an Accounting Order permitting it to defer and capitalize, for later recovery through rates, all non-fuel costs of owning, operating, and maintaining the acquired SCE interest in Four Corners Units 4&5 and associated facilities be, and hereby is, granted. Costs to be deferred include depreciation, amortization of the acquisition adjustment, decommissioning costs, operation and maintenance costs, property taxes, final coal reclamation costs, carrying charges, and miscellaneous other costs. The carrying charges shall be computed using the embedded cost of debt as of December 31, 2010 and the 11% cost of equity used in Arizona Public Service Company's last general rate case, at the ratio of 46.21% debt and 53.79% equity also set in that rate case.
>
> IT IS FURTHER ORDERED that Arizona Public Service Company shall reduce the deferral by non-fuel operations and maintenance and property tax savings associated with the closure of Four Corners Units 1-3.
>
> IT IS FURTHER ORDERED that Arizona Public Service Company shall be allowed to recover all unrecovered costs associated with Four Corners Units 1-3 and any additional costs incurred in connection with the closure of Four Corners Units 1-3.

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[86] Exh. RUCO-1, Fish Direct at 31-32.
[87] Tr. Vol. IV at 579, 592.

> IT IS FURTHER ORDERED that Arizona Public Service Company shall be allowed to defer a return on all of the deferred costs computed using the embedded cost of debt as of December 31, 2010 and the 11% cost of equity used in Arizona Public Service Company's last general rate case, at the ratio of 46.21% debt and 53.79% equity also set in that case until the inclusion of any such unrecovered costs in rates in Arizona Public Service Company's next rate proceeding.[88]
>
> IT IS FURTHER ORDERED that the accumulated deferred balance, including the related deferred return, associated with all amounts deferred pursuant to this Decision will be included in cost of service and rate base for ratemaking purposes. Nothing in this Decision shall be construed to limit the Commission's authority to review such balance and to make disallowances thereof due to imprudence, errors or inappropriate application of the requirements of this Decision.

APS is seeking to include in its deferral a carrying cost applied to all other deferrals and the compounded value of those carrying costs. However, it is inappropriate to allow carrying charges or the compounding of those carrying costs. Staff believes that assessing the merits of an accounting order involves both a qualitative and quantitative evaluation. Allowing APS to both defer the capital costs associated with the purchase as well as applying a carrying charge inaccurately suggests that these factors can be identified and refined to a high degree.[89]

Furthermore, regulatory lag, which the Company cites as a reason for authorizing the accounting order, is a reason why the Company should not be able to defer capital costs and earn a return on deferred amounts. The Company will actually be able to take advantage of regulatory lag once the asset is placed in rate base and rates are set inclusive of the asset. Although the rates remain constant in between rate cases, the asset is depreciated and the cost of financing may go down even though the Company will continue to collect those additional capital costs from ratepayers.[90] This over collection of capital costs compensates the Company for the "lag" that occurs when the asset is purchased but before it is placed in rates. Accordingly, Staff believes allowing for a deferral of a return and earning a return goes beyond finding a balance of interests between the Company and its ratepayers and leans more towards providing a guarantee to the Company.

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[88] Application Attachment B; Exh. S-3, Michlik Direct at 2.
[89] Exh. S-3, Michlik Direct at 10.
[90] Tr. Vol. V at 905.

Staff recommends authorization of an accounting order with the following provisions:

1. That APS may defer, for future consideration of recovery through rates, all non-fuel costs of owning,[91] operating and maintaining the acquired SCE interest in Four Corners Units 4 and 5 net of non-fuel operation and maintenance and property tax savings associated with the closure of Four Corners Units 1 through 3;
2. Denial of APS' request for assurance of recovery for all unrecovered costs associated with Four Corners Units 1 through 3; however, APS shall account for those costs under the assumption that the Commission will continue to consider those costs available for future recovery unless and until otherwise determined (i.e., these costs should not be prematurely written off);
3. Denial of APS' request for assurance of recovery for any additional cost incurred in connection with the closure of Four Corners Units 1 through 3; however, APS shall account for those costs under the assumption that the Commission will continue to consider these costs available for future recovery unless and until otherwise determined (i.e., these costs should not be prematurely written off);
4. Denial of APS' request to apply a cost of money, i.e., return, of any deferred amounts.
5. That the authorization of a cost deferral not constitute a finding of determination that the deferred costs and proceeds are reasonable, appropriate, or prudent; that such authorization not be construed as providing any relief through rates with respect to the ultimate recovery of the above-authorized deferrals; and that such authorization not be construed to limit the Commission's authority to review the deferred balance and to make any disallowances thereof;
6. That APS prepare and retain accounting records sufficient to permit detailed review, in a rate proceeding, of all deferred costs and cost benefits as authorized above;

[91] Staff does not believe that carrying costs are costs of owning that should be included in an accounting order since they are recoverable in the context of a rate case. Tr. Vol. V at 1051.

7. That APS prepare a separate detailed report of all costs deferred under this authorization and that APS include that report as an integral component of each of its general rate applications in which it requests recovery of those deferred costs;

8. That APS file each January with Docket Control, as a compliance item in this docket, an annual status report for each preceding calendar year, of all matters related to the deferrals, and the cumulative costs thereof, with the first such report due no later than January 2012; and

9. That the Decision in this matter becomes effective immediately.

During the hearing APS agreed with these recommended provisions with the exception of provision number four regarding cost of capital. In addition, APS proposed alternative language that it prefers for provision number one.[92]

C. <u>The Accounting Order Should Not Include a Deferral of Any Cost of Capital Associated with the Purchase of SCE's Share of Units 4 and 5.</u>

The Company acknowledges that the central point at issue regarding the scope of the accounting order in this matter is to what extent it includes the deferral of the cost of capital associated with the purchase and a return on those amounts deferred.[93] In support of its request to include a deferral of capital costs and a return on other deferred costs the Company cites to four other jurisdictions where commissions have allowed for a deferral of capital costs.[94] In addition, the Company cites to three Decisions from this Commission where APS claims the Commission allowed the Company to defer capital costs: Decision Nos. 55325, 55939, and 67504.

Decision Nos. 55325 and 55939 are from the mid to late 1980's and involve the construction of the Palo Verde Nuclear Generating Station ("Palo Verde") Units 2 and 3. While Staff acknowledges that the Commission allowed APS to defer capital costs in the deferral orders granted, the circumstances surrounding the construction of Palo Verde are not comparable to the purchase of SCE's share of Units 4 and 5 of Four Corners. An important distinction that the Commission has recognized in the past, that is equally applicable here, is that Palo Verde involved the construction of

[92] Tr. Vol. IV at 732, 757.
[93] *Id.* at 757.
[94] See Exh. APS-15, Guldner Rebuttal at 11.

a power plant whereas the transaction in this case involves the purchase of an existing power plant.[95] Further, the Company acknowledges that Palo Verde involved billions of dollars and this transaction involves millions of dollars.[96] In other words, the dollar amounts involved with Palo Verde would potentially have a significantly greater impact on APS than the dollar amounts involved in this case.

The Company also cites to the more recent Decision No. 67504 ("PPL Sundance Decision") in support of its request to include the deferral of capital costs as a component of an accounting order. In that case, APS sought, *inter alia*, an accounting order associated with the purchase by APS of the Sundance Generating Station. However, APS misinterprets the scope of the accounting order authorized in the PPL Sundance Decision. In that Decision, the Commission indicated as follows:

> Once the prudently incurred costs of the Sundance Generating Station have been determined in the context of a rate case in which all factors have been considered, APS should certainly be authorized to earn a return on its prudent investment, but it **should not** earn that return retroactively to the acquisition date. Allowing a deferral **of** a return on the deferred balance in addition to deferral of the costs prior to the plant's inclusion in rate base would unreasonably skew the benefits of regulatory lag in favor of the shareholders to the detriment of the ratepayers. As discussed above, once the plant is in rate base, APS will continue to earn a return on the plant after the plant's actual retirement but before it is removed from rate base in a rate case.[97]

(emphasis added).

While Staff evaluates each case on its own merits, the Commission's reasoning in the PPL Sundance Decision is equally applicable, and more comparable to this case than the much earlier Palo Verde decisions cited by APS. The dollar amounts at issue are more comparable.[98] They both involve the purchase of a plant and not the construction of a new plant.[99] Further, APS acknowledges that there may be a time after SCE's share of Units 4 and 5 are purchased and when Units 1 – 3 are still being recovered through rates even though they are retired.[100] Further, the Company

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[95] Decision No. 67504 at 22.

[96] Tr. Vol. V at 903.

[97] Decision No. 67504 at 30.

[98] The purchase price for PPL Sundance was approximately $189 million, and the purchase price for SCE's share of Four Corners Units 4 and 5 is approximately $294. The construction of Palo Verde cost billions of dollars (Decision No. 67504 at 22).

[99] Decision No. 67504 at 22.

[100] Tr. Vol. V at 890.

acknowledges that when an asset is placed in rate base, rates are not lowered as the asset is depreciated even though the cost of financing may go down.[101] So in this case, not only will APS ultimately be made whole due to regulatory lag and the timing of rate cases as it relates to the capital costs for the purchase of SCE's share of Units 4 and 5, but it will also continue to benefit from regulatory lag related to depreciation expense for Units 1 – 3 until they are ultimately removed from rate base in a future rate case. For these reasons, Staff believes that any accounting order authorized in this matter should not include a cost of capital as part of that deferral.

D. Staff's Proposed Accounting Order Language is More Appropriate.

APS suggests that Staff's proposed deferral language should be replaced with language that allows APS "to defer for later recovery the prudent and reasonable non-fuel costs of owning, operating, and maintaining the acquired SCE interest...."[102] However, Staff believes its proposed deferral language is more appropriate in this case for several reasons.

First, the language APS is seeking is the identical language that was used in a prior settlement agreement that was adopted by the Commission in Decision No. 67744.[103] This language was presumably constructed as part of the settlement and was based on a compromise between the parties and not a litigated proceeding.

Second, while an accounting order, in general terms, may be a ratemaking tool, it should be tailored to the specific expenses sought to be deferred. The language that APS is recommending was for the deferral of remediation expenses associated with the removal of trees infested with bark beetles that were within falling distance of APS' power lines. While that language may have been appropriate in the context of a settlement agreement for tree removal expenses, Staff does not believe that same language is appropriate for the deferral of non-fuel costs of owning, operating and maintaining the acquired SCE interest in Four Corners Units 4 and 5.[104]

Staff believes its proposed language is superior to that of the Company because it does not give the perception that there is a predetermination as to the recoverability of any deferred costs prior

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[101] Tr. Vol. V at 905 – 909.
[102] Exh. APS-15, Guldner Rebuttal at 13.
[103] *Id.*
[104] Tr. Vol. V at 1067.

to them being considered in a subsequent rate case.[105] However, Staff would also support the use of the deferral language set forth in Decision No. 67504 that "Arizona Public Service Company is authorized to defer, for possible later recovery through rates...." It is important to note that the purpose of an accounting order is to preserve the opportunity to have recovery of certain costs considered in the future.[106]

IV. CONCLUSION.

Staff believes APS has adequately addressed the five criteria required by the Commission in Decision No. 67744. Accordingly, Staff recommends that the Commission waive the moratorium in order to allow APS to acquire SCE's interest in Four Corners Units 4 and 5, if APS so desires.[107] However, Staff is not recommending that the Commission approve the acquisition itself, nor is Staff making any recommendation that APS should purchase SCE's interest in Units 4 and 5.[108]

Staff further recommends that the circumstances surrounding the proposed transaction warrant Commission approval of an accounting order with the provisions identified in Section III, *supra*.

RESPECTFULLY SUBMITTED this 30th day of September, 2011.

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[105] Tr. Vol. V at 1073, 1067.
[106] Exh. S-3, Michlik Direct at 11.
[107] Exh. S-2, Furrey Direct at 4.
[108] Tr. Vol. V at 1037-1038.

Original and thirteen (13) copies of the foregoing filed this <u>30th</u> day of <u>September</u>, 2011, with:

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