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BEFORE THE ARIZONA CORPORATION COMMISSION

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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 FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN, AND FOR APPROVAL OF PURCHASED POWER CONTRACT.	DOCKET NO. E-01345A-03-0437

Arizona Corporation Commission
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NOTICE OF FILING TESTIMONY

Pursuant to the amended procedural order in this matter dated February 20, 2004, the ARIZONA UTILITY INVESTORS ASSOCIATION (AUIA) hereby submits the rebuttal testimony of Walter W. Meek.

Respectfully submitted, this 30th day of March, 2004.

Walter W. Meek

Walter W. Meek, President

CERTIFICATE OF SERVICE

An original and 13 copies of the referenced testimony
filed this 30th day of March, 2004, with:

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

Copies of the referenced testimony
hand delivered this 30th day of March, 2004, to:

Christopher Kempley, Esq., Legal Division
Lyn Farmer, Esq., Hearing Division
Ernest Johnson, Esq., Utilities Division

A copy of the referenced testimony was
mailed this 30th day of March, 2004, to:

Thomas L. Mumaw, Esq.
Pinnacle West Capital Corporation
P.O. Box 52132
Phoenix, AZ 85072-2132

Parties of Record

REBUTTAL TESTIMONY OF WALTER W. MEEK

I. INTRODUCTION, QUALIFICATIONS AND PURPOSE OF TESTIMONY

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 the president of the Arizona Utility Investors Association ("AUIA"), a non-profit organization formed to represent the interests of equity owners and bondholders who are invested in utility companies that are based in or do business in the State of Arizona.

Q. DOES AUIA'S MEMBERSHIP INCLUDE SHAREHOLDERS WHO HAVE EQUITY INTERESTS IN ARIZONA PUBLIC SERVICE COMPANY (APS)?

A. Yes. APS is a wholly owned subsidiary of Pinnacle West Capital Corporation (PWCC). AUIA's largest membership block consists of common stockholders in PWCC.

Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?

A. On behalf of AUIA, an intervenor in this proceeding.

Q. HAVE YOU FILED TESTIMONY PREVIOUSLY IN THIS DOCKET?

A. No. AUIA did not file direct testimony. We are filing rebuttal concurrently with APS' rebuttal because AUIA's position is more closely aligned with that of the company than with other parties.

Q. CAN YOU SUMMARIZE THE ELEMENTS OF YOUR TESTIMONY?

A. Yes. I will present my testimony in seven parts plus a conclusion. First, I will provide an overview of the impact of the Staff recommendations, with particular emphasis on their reception by the financial community. In that context, I will discuss the perception of the regulatory environment created by the Staff proposals and their probable financial effect on the company and its investors.

Second, I will discuss a recent legal development, which I believe undermines the Staff position on important rate case issues.

Next, I will discuss five specific issues in the rate case, including: rate-basing the Pinnacle West energy Corp. (PWEC) units; restoring the $234 million write-off; return on equity; the need for a purchased power and fuel adjustment clause (PPFAC); and the alleged violations of the electric competition rules.

In the course of discussing these specific issues, I will refer to the direct testimony of Staff witnesses Linda Jaress, Lee Smith, Douglas Smith and Joel Reiker.

Q. WOULD YOU PLEASE EXPLAIN WHY YOU ARE QUALIFIED TO PROVIDE TESTIMONY ON THIS SUBJECT MATTER?

A. I represent the largest cross-section of utility stockholders in the State of Arizona and I have been involved with the utility business in Arizona for 28 years. I have participated in dozens of Commission dockets on behalf of AUIA and testified in numerous proceedings. My testimony has covered topics including rate of return issues, stranded costs, disposition of regulatory assets, AFUDC, inclusion of CWIP in rate base and the impact of regulatory decisions on analyst and investor expectations.

Q. ARE YOU TESTIFYING AS AN EXPERT WITNESS?

A. Not really. I will attempt to bring a "real world" investor perspective to some of the complicated technical issues raised by the rate case.

Q. HAVE YOU PERSONALLY PURCHASED AND SOLD COMMON STOCK OR OTHER EQUITY INSTRUMENTS?

A. Certainly, both in and outside the utility arena. Currently, I own stock in several utilities that do business in Arizona, including Pinnacle West Capital Corporation.

Q. IN YOUR POSITION WITH AUIA, HAVE YOU DISCUSSED INVESTING IN COMMON STOCKS OF UTILITIES AND/OR OTHER CORPORATIONS?

A. Yes. Investment in stock, particularly stock in utilities, is the foundation of AUIA's existence. In order to advance the interests of AUIA's members, I have developed a good working knowledge of the utility industry and, specifically, investment related matters.

Q. ARE YOU FAMILIAR WITH THE CRITERIA THAT A TYPICAL INVESTOR MIGHT CONSIDER WHEN EVALUATING WHETHER TO INVEST IN A UTILITY'S STOCK?

A. I believe I am. At the outset, it may be useful to distinguish between institutional and retail investors. Today, between 60 and 80 percent of the outstanding shares of some utilities are held by institutional investors, such as pension plans and investment trusts. Of the remainder, half or more may be held in "street" name by broker-dealers and the rest are shareholders of record on the corporate books.

Although all investors should in theory employ similar investment criteria, some have access to more information than others. A careful investor evaluating whether to invest in a utility would examine several factors such as liquidity and cash flows, debt service coverage, capital structure, customer growth, capital requirements, return on equity, PE ratio, projected earnings and dividend growth and regulatory risk in addition to specific business conditions. Some institutional investors are prohibited from investing in a company that doesn't pay a dividend.

Retail investors may or may not have professional investment advisors, but they should be interested in the same company-specific data and factors, although their analysis is typically less complex. Since many are at or near retirement age, they are in the "fixed-income" syndrome; they want safety along with consistent growth in earnings and dividends. People in this category often do not have the option of diversification and will have a "portfolio" of just three or four dividend paying stocks.

II. OVERVIEW OF STAFF RECOMMENDATIONS

Q. DOES AUIA SUPPORT THE COMPANY'S RATE APPLICATION?

A. In most respects, yes. AUIA believes that the quality of Pinnacle West's earnings is eroding rapidly, due primarily to the deterioration of earnings power at APS. In order to maintain the ability to attract capital at reasonable cost and provide reliable service to a rapidly growing customer base, APS must have rate relief. The minimum components of rate relief include a reasonable return on equity (ROE), rate-basing generation assets and providing insulation against price volatility in power and fuel markets.

Q. WHAT IS AUIA'S REACTION TO THE STAFF'S RECOMMENDATIONS IN THIS CASE?

A. We think it is potentially disastrous for the company's short-term financial condition and also for its long-term positioning with the financial community. Financial analysts expressed disbelief at the Staff's reaction and they are now conditioned to believe that APS is subject to the most negative regulatory environment in the country.

For myself, if I thought for a moment that the Staff's proposal would be adopted by this Commission, I would dispose of my Pinnacle West stock immediately and would advise anyone who asked me to do the same.

Q. WHY WAS THE STAFF'S RESPONSE SO UNEXPECTED?

A. That requires some historical context. Since 2000, Arizona electric companies, of which APS is the largest, have created an island of tranquility, with no price increases and no supply shortages, while the electricity markets everywhere else in the western interconnection have experienced turmoil. In APS' case, customers have experienced 10 years of price decreases totaling 16 percent along with completely stable electric supplies.

It was inexplicable to the utility industry and the investment community that APS' performance would be rewarded with such a punishing recommendation from Commission Staff.

Furthermore, the entire financial community has been holding its breath on Pinnacle West, awaiting a favorable outcome in the rate case. Of the 14 analysts who make buy/sell recommendations on PWCC, only one has produced a buy recommendation in 2004. All of the others have adopted neutral or hold ratings.

Pinnacle West's earnings have been under pressure from the cumulative rate cuts since 1999. The problem was effectively masked in 2000 and 2001 by cost-cutting measures and extraordinary revenues in marketing and trading (M&T) that resulted from the western energy crisis. Since then, M&T revenues have evaporated and rising gas prices and other operating costs have crippled APS' earning power.

In 2002, PWCC earnings per share (EPS) fell 11 percent from the previous year. In 2003, EPS fell another 26 percent, from $3.56 per share to 2.63 per share. More troubling is the fact that APS' contribution fell from $2.61 to $1.98 per share, barely enough from the core business to cover the parent company's indicated shareholder dividend of $1.80.

But it gets worse. Of PWCC's $2.63 in EPS in 2003, 61 cents came from SunCor, Pinnacle West's real estate subsidiary. Without that contribution, PWCC earnings would have been off 43 percent from the previous year. The majority of SunCor's robust earnings are being produced through cannibalizing the company's mature assets, a strategy designed to reduce Pinnacle West debt. Financial analysts know that this strategy can only continue for a couple of years.

Q. WHAT ABOUT THE RECOMMENDATION OF THE RESIDENTIAL UTILITIES CONSUMERS OFFICE?

A. Although RUCO's recommendation is less drastic than the Staff's, it is just as unacceptable, since it also calls for a rate reduction and sidesteps the issue of rate-basing the PWEC units. RUCO's position received little attention from the financial community in comparison with the Staff response because there is more concern among analysts that the Staff position might be reflective of Commission sentiment.

II. A. <u>A SHOCK TO THE FINANCIAL COMMUNITY</u>

Q. HOW DID THE INVESTMENT COMMUNITY REACT TO THE STAFF AND RUCO RECOMMENDATIONS?

A. Against the background I have just described, the financial community was shocked by the Staff recommendations and, to a lesser degree, by RUCO's. Actually, there were two levels of response. One reacted to the perceived regulatory climate reflected in the Staff recommendation and the other dealt with the financial and stock price implications.

Q. WHAT WAS THE REACTION WITH REGARD TO THE REGULATORY CLIMATE?

A. I will offer some verbatim examples of analysts' comments, which were published on February 4 or February 5, 2004, in response to the Staff's recommendations:

- Citigroup reported that the Staff filed "punitive rate case testimony."
- Credit Suisse described the propose ROE as "extreme."
- J. P. Morgan described the Staff's proposal as "Regulators 1, Investors 0," and went on to say that the Staff "set a more punitive return requirement than any other commission has implemented."
- Lehman Brothers referred to the "extreme nature" of the Staff recommendation.
- Merrill Lynch titled its report, "Extreme Staff Recommendation," and added, "the 9% ROE would be the lowest we have ever seen allowed by any state, let alone one like Arizona where rapid growth requires significant capital investment."
- UBS Investment Research called the Staff and RUCO positions "significantly worse treatment of APS than we had anticipated."
- Deutsche Bank Securities called the Staff testimony "a surprisingly adversarial filing," and called the proposed revenue requirement "punitive."

• Harris Nesbitt Gerard called the recommended ROE "paltry in comparison with recent decisions in other states (which have ranged from 9.5% -12%+)."

Q. IS THERE A COMMON THEME TO THESE REACTIONS?

A. There are a couple. First, there is the perception that the Commission Staff's recommendations are extreme and punishing. Second, there is the perception that the Staff's approach is irrational, given the company's history and results in other jurisdictions.

Q. WHAT IS THE SIGNIFICANCE OF THESE PERCEPTIONS?

A. Today, assuming that a utility company has good fundamentals and limited exposure to the commodity market, the next most important variable for financial analysts and rating agencies is its regulatory environment. It is a litmus test that can determine whether a company gets the benefit of the doubt about forthcoming regulatory issues and rating actions. These reactions show that the financial community believes that the response of Commission Staff to APS' plight is punitive and irrational. Depending on how this plays out, they are poised to conclude that APS has entered into a destructive relationship with the Commission or that the regulatory environment in Arizona has become inhospitable to investors.

II. B. DIRE FINANCIAL PROJECTIONS

Q. HOW DOES THE FINANCIAL COMMUNITY VIEW THE POTENTIAL IMPACT OF THE STAFF RECOMMENDATIONS?

A. Most of the financial community is in a state of disbelief over the Staff recommendations. They simply cannot accept that the Commission will reach a conclusion that is even close to the Staff's position. As a result, there has been minimal analysis of the potential impact of the Staff recommendations. The few projections that have been made are just short of disastrous.

Q. WHY IS THE STAFF RECOMMENDATION SO UNACCEPTABLE?

A. Primarily because APS and Pinnacle West start from such a bad position. For example, in January, before the Staff's filing, Citigroup's assessment was that the company's earnings mix would continue to be poor in 2004 and 2005 without rate relief, buoyed only by SunCor's contributions. Citigroup forecast that a zero rate increase would produce an ROE below 9 percent for PWCC, which would be non-competitive in the financial markets. Then they were confronted with a Staff recommendation for an 8 percent reduction in APS rates. If such a recommendation became reality, the analysts would trash the company's stock.

Q. WHAT PROJECTIONS HAVE THE ANALYSTS MADE?

A. Among the few specific projections, Lehman Brothers and Merrill Lynch estimated that the Staff recommendation would reduce earnings at PWCC to $2.00 per share in 2005, a reduction of 24 percent from 2003 and 44 percent from 2002.

Q. WHAT WOULD BE THE IMPACT ON EARNINGS AT THAT LEVEL?

A. I can't give a precise answer. I can generalize by saying that I believe that every financial activity at APS and Pinnacle West would be threatened. Cash generation would be crippled; the indicated dividend would approach 92 percent payout and could not be sustained; debt coverage and credit rating would be at risk; the ability to raise capital would be damaged.

Citigroup estimates that even at a midpoint in ROE – between the Staff's 9 percent recommendation and the company's 11.5 percent request –

PWCC's cash generation and cash-to-dividend ratio would be two to three times worse than all of its peers.

Q. **WHAT POSITIONS HAVE MOST OF THE ANALYSTS TAKEN?**

A. Most of them have adopted interim positions based on an expected compromise of the Staff and company positions. Typically, they are forecasting earnings in the range of $3.10 to $3.25 per share for 2005, although they have given up on any improvement in 2004. They recommend holding the stock but not buying it. Until the rate case is concluded, the hold recommendation is supported primarily by the dividend yield, now at about 4.6 percent.

Q. **WHAT ASSUMPTIONS HAVE THE ANALYSTS MADE?**

A. There is the rub. The neutral positions taken by the analysts generally reflect a common set of assumptions:

• A rate of return on equity between 10 and 11 percent, well above the Staff's recommendation. Analysts estimate that a swing of 100 basis points in ROE affects 25 to 30 cents in earnings per share.

• Rate-basing the PWEC units. As I will discuss in more detail below, the financial community cannot believe that this is in dispute, because of the obvious damage it does to the earnings and credit metrics of PWCC and APS. Their perspective is that without rate-basing, APS and its customers will be exposed to dangerous market volatility. When they factor in the absence of a PPFAC, the effect is a double whammy, exposing the company's future earnings to the same forces that sank earnings in 2003.

Q. **WHAT ABOUT DEBT COVERAGE AND CREDIT RATINGS?**

A. There is no way to be precise about those effects with the rate case unresolved, but we do have troubling indications.

On February 12, 2004, Moody's Investors Service changed the rating outlook for APS and Pinnacle West from stable to negative. Moody's said that both the Staff and RUCO recommendations "would weaken credit metrics at APS and at PWCC, since revenues and cash flows would decline by a substantial amount."

Moody's also noted that the utility added $500 million of debt to its balance sheet last year to fund the intercompany note between APS and PWCC.

On Feb. 4, Standard & Poor's (S&P) reacted quickly to the Staff recommendation with the warning that, "if implemented by the commission, the recommendations could result in negative rating actions."

On March 19, S&P followed up with a more detailed report, which changed the rating outlook for both APS and Pinnacle West from stable to negative. According to S&P, "The negative outlook reflects a potentially declining financial profile in the intermediate term, despite expectations of reasonably supportive regulatory rate-making decisions later this year."

Significantly, S&P added, "If the ACC were to rate-base all, or a significant portion, of PWEC's generating assets, the business profiles of PWCC and APS may strengthen sufficiently for Standard & Poor's to consider applying less stringent financial benchmarks in its evaluation of the outlook." (Emphasis added)

Q. DO YOU ATTACH PARTICULAR SIGNIFICANCE TO THESE COMMENTS?

Yes. I thought it was clear from the comments of the rating agencies that surfaced during the APS financing docket that they expected the PWEC units to be placed in rate base at some point, sooner rather than later. That view has now been confirmed in the most recent comments of both agencies. In its Feb. 4 communication, S&P noted that the Staff recommendations "represent a significant departure from the direction indicated by the ACC in recent decisions that have supported APS' credit quality."

In addition, the Commission should note that the credit outlooks for both APS and Pinnacle West are now married in the agencies' analysis. In other words, it is probably not possible in most circumstances to undermine the credit metrics of Pinnacle West without affecting APS' credit quality.

Staff witness Joel Reiker asserts that Staff's recommendation will result in debt coverage for APS of 3.1 to 1, sufficient to support an AA credit rating from Standard & Poor's. Even if his calculations are accurate, they exclude the PWEC units and their associated debt. The financial analysts and rating agencies can't ignore those assets and liabilities when they assess Pinnacle West's condition.

Perhaps the relevant question is if Pinnacle West's credit deteriorates, how long will it be before it stains APS' credit rating? If the Staff recommendation erodes PWCC's earnings to the point that it can't reduce debt before the SunCor bonanza runs out, there will be an inevitable clash between its debt obligation to APS and its other fiduciary responsibilities.

Q. CAN YOU SUMMARIZE THE FINANCIAL COMMUNITY'S REACTION TO THE STAFF RECOMMENDATIONS?

A. In a nutshell, the financial community was shocked by the Staff response and considered it radical and punitive. Although it is clear that they consider the financial ramifications potentially disastrous, they refuse to accept that the Staff view will prevail. For the most part, they have adopted a neutral, wait-and-see attitude based on assumptions that the company will make significant headway on key rate case issues.

Q. MR. MEEK, ARE YOU SUGGESTING THAT THE COMMISSION'S DECISION MUST MATCH THE EXPECTATIONS OF WALL STREET?

A. Absolutely not. But the Commission should be cognizant of two things. First, the financial community is as well qualified as any other party in this proceeding to judge the business and financial efficacy of the parties' positions. Second, Pinnacle West and APS have to operate in the debt and equity markets and the judgments of the financial community will ultimately affect the companies' cost of doing business and the cost of providing service to their customers.

III. THE IMPORT OF THE ARIZONA COURT OF APPEALS

Q. CAN YOU EXPLAIN THE LEGAL DEVELOPMENT YOU MENTIONED IN YOUR INTRODUCTION?

A. Yes. On January 27, 2004, the Arizona Court of Appeals issued its opinion and order in *Phelps Dodge Corporation, et al v. Arizona Electric Power Cooperative, et al.* In that opinion, the court ruled that several of the Corporation Commission rules governing electric competition are illegal or unconstitutional. In particular, the court declared that the Commission lacked constitutional or legislative authority to enact A.A.C. 14R-2-1615 (A) and (C).[1]

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[1] See *Phelps Dodge Corporation, et al v. Arizona Electric Power Cooperative, et al,* 1 CA-CV 01-0068, Court of Appeals, Div. One, Opinion filed Jan 27, 2004, P. 42, ¶ 69

Q. WHAT DO THOSE SECTIONS PROVIDE?

A. Those are the sections of the electric competition rules that required affected utility companies to divest their generating assets to either an affiliated entity or to an unaffiliated third party.

Q. WHAT IS THE IMPORT OF THE COURT DECISION IN THIS CASE?

A. In AUIA's view, the decision of the Court of Appeals invalidates Staff's entire position regarding the rate-basing of the so-called PWEC units and renders meaningless the long-winded discussions (theirs and mine) about whether APS and PWEC may have violated the electric competition rules.

Q. ARE YOU OFFERING A LEGAL OPINION?

A. No legal opinion is required. The Court of Appeals was unequivocal in its ruling. My conclusion is the product of common sense and the ability to read. For the record, I would like to recall that AUIA argued repeatedly to the Commission in 1996 -1999 that it had no authority under the Arizona Constitution to require utilities under its jurisdiction to divest their generating resources.

Q. PLEASE EXPLAIN YOUR CONCLUSION REGARDING RATE-BASING.

A. APS was required by the rules cited earlier to divest its generation by the end of 2001, a deadline that was amended to December 31, 2002. APS chose the option of divesting to an affiliate. It formed Pinnacle West Energy Corp. (PWEC) to serve that purpose as an exempt wholesale generator unregulated by the Corporation Commission. With divestiture imminent, when APS determined that its load growth required new generation, it decided to build that capacity within PWEC. That capacity added up to five units totaling nearly 1,800 megawatts and about $1 billion of investment. It is the existence of that generation at PWEC, rather than APS, that is at the root of the rate-basing issue.

Q. AND THE EFFECT OF THE APPEALS COURT DECISION?

A. It turns out that the order to divest was unconstitutional. The Commission had no authority to require it. Without the divestiture requirement, PWEC would not have existed. It becomes the fruit of the poison tree. Without PWEC, there would have been no unregulated repository for new generation and APS would have built and owned the units.

Q. DIDN'T THE COMMISSION AMEND THE RULES TO CANCEL DIVESTITURE IN ITS TRACK A ORDER?

A. Yes, but by then the damage had been done: PWEC had been formed, the units had been built by and were owned by an unregulated affiliate and every merchant generator in the state was battling to prevent the units from being rate-based at APS. In Track A, the Commission chose to sidestep the issue of the PWEC units.

Q. WHAT ARE THE APPROPRIATE RATE CASE ISSUES REGARDING THE PWEC UNITS?

A. In her direct testimony, Staff witness Linda Jaress said, "The prudence of the construction and cost of construction of assets owned by a non-utility enterprise (PWEC) is irrelevant to the determination of APS' rate base." She is precisely wrong. Given the fact that the Commission's order to divest was illegal, the only appropriate issues related to the PWEC units are prudence and whether they are used and useful. If the Commission were to accept Ms. Jaress's approach, a court could construe its action as a regulatory taking.

Q. IS THAT A LEGAL CONCLUSION?

A. No. That is a legal hankering and I hope it's convincing.

IV. THE PWEC UNITS BELONG IN RATE BASE

Q. WHAT IS AUIA'S POSITION ON RATE-BASING THE PWEC UNITS?

A. Obviously, we favor rate-basing. Putting aside the issue of the illegal order to divest, the logic of rate-basing seems irrefutable. These units have been serving electricity to APS customers from the first day they went on line and even with their full utilization, APS will experience a capacity deficit in 2004. The fact that they are cost-competitive is demonstrated by the Track B results and the responses to the APS request for proposals for long-term capacity. These results fulfill the classic requirements for determining the prudence of construction and that they are used and useful.

Q. WHAT IS THE STAFF'S OBJECTION TO RATE-BASING?

A. There seem to be two basic objections, both enunciated by Ms. Jaress. The first is that APS didn't demonstrate that the PWEC units "represent the best economic choice for its customers." The second is that these units were, in reality, merchant plants not dedicated to serving APS customers.

Q. WILL YOU RESPOND TO THE FIRST OBJECTION?

A. It's hard to fathom the reasoning here and we may be dealing with an incidence of Staffspeak. In the first place, in the quotation attributed to Ms. Jaress on the previous page, she rejected outright any discussion of prudence as irrelevant to this proceeding. Yet, it seems to me the "best economic choice" for a utility's customers is the essence of prudence.

Next, it's difficult to understand her frame of reference. At the time these units were planned and construction was initiated, there were no choices. California and the rest of the West were experiencing shortages due to inadequate generation and transmission and severe price spikes were occurring. As the California crisis unfolded, there was a cascade of announcements about new construction in Arizona, but almost none of it was guaranteed to be in place by the summer peaks of 2002 and 2003 or even today.

Q. HAS STAFF SUGGESTED BETTER CHOICES?

A. No. Ms. Jaress offered no evidence or indication of better choices. Staff would probably argue that the company has the burden to show that its choice was the right one, but I would argue that there is certainly recent anecdotal evidence to support that decision.

The results of the Track B solicitation disclosed that the competitive generation pool is anemic even today, never mind three and four years ago when the PWEC units were committed. In addition, the preliminary results of the RFP indicate that the PWEC units are competitive because their costs are at the low end of the range of bids, from $65 to $160 per megawatt-hour. In addition, many of the bidders were burdened by poor credit quality and inadequate transmission.

Q. HAS THE FINANCIAL COMMUNITY WEIGHED IN ON THIS ISSUE?

A. Yes. The financial community strongly favors rate-basing to improve APS' earning capability and lower its exposure to market volatility and to reduce the financial risk to Pinnacle West. They cannot understand the Staff's arguments against rate-basing. Here are some sample opinions:

- Even assuming an 11 percent ROE for the rate-based units, Citigroup's analysis on Jan. 29 was that the PWEC units were competitive with the bidders that responded to the RFP.

• On Feb. 4, Credit Suisse/First Boston said, "Considering the results of the Track B auction -- where PWEC's assets offered the best economic option -- and the limited number of quality bids at the most recent RFP, we are particularly surprised at the Staff's decision (on rate-basing)."

• On Feb. 4, Merrill Lynch said, "Moreover, the decision on the PWEC assets does not seem to account for the long-term customer needs for this power, particularly for the West Phoenix plants that are in the Phoenix load pocket."

• On Feb. 5, Banc of America Securities said, "it is hard for us to imagine a move of the company's 1,800 megawatts of dedicated generation to rate base not being approved, particularly in light of the recent Track B solicitation results."

Q. CAN YOU COMMENT ON STAFF'S ASSERTION THAT THE PWEC UNITS WERE MERCHANT PLANTS, NOT DEDICATED TO APS?

A. Yes, with the caveat that I believe that the Court of Appeals has obviated this issue. In the first place, the fact that these facilities were built as merchant plants is not headline news. PWEC was a merchant provider. That's what the divestiture rules required it to be. Had divestiture gone forward, every plant in the APS arsenal would have been a merchant plant, by definition.

That doesn't mean they wouldn't have been dedicated to serve APS. Regardless of divestiture or the condition of the wholesale market, the company had the ongoing and unending responsibility to provide for 100 percent of its customers needs, if required.

The fact is that the PWEC plants have been serving APS customers since they were constructed and APS would not have met its load since 2001 without them. Almost every intermediate or base load plant that a utility builds, even under regulated vertical integration, starts out with a split personality -- partly in the wholesale market and partly serving native load -- until load growth catches up to capacity.

Q. **ARE THERE OTHER STAFF ASSERTIONS ABOUT THE PWEC PLANTS?**

A. Yes, unfortunately, Ms. Jaress comes close to calling key Pinnacle West executives liars. She cites statements made by Bill Post (Pinnacle West Chairman and CEO), Jack Davis (APS CEO), Bill Stewart (PWEC CEO) and Ed Fox (PWCC Vice-president) in different venues to show that they said allegedly contradictory things about the role of PWEC's generation and its business plans.

I won't dignify this innuendo by countering it in detail. Instead, let me suggest that this Commission handed these guys a very difficult job, all in the name of a flawed concept that turned into a train wreck. After 1999, neither they nor the financial community had a clear idea what business they were in.

Mr. Post had the job of trying to convince the financial community that he could successfully operate a regulated utility and also make profits from merchant power plants and wholesale marketing. Mr. Davis had to act confident about running a growing utility company with no power plants. Mr. Stewart had to talk the talk and walk the walk of a merchant generator cut adrift from the utility. Of course these people said some things that sound contradictory today, but that doesn't change the fact that APS had to meet its load and did it with the PWEC generation.

Q. **IS THE APS CODE OF CONDUCT AN ISSUE IN RATE-BASING?**

A. Not in my opinion. Once again, AUIA holds that the Court of Appeals decision makes this issue irrelevant. However, Ms. Jaress offers a subjective conclusion that the code of conduct would not have precluded APS from building new generation even in the face of divestiture. We disagree, but let's look at it from another perspective, a different scenario.

Suppose it's about mid-2001 and APS has concluded that to maintain service to its customers it must build new generation. It has a brand spanking new, unregulated wholesale generating company up and running. It faces forced divestiture of all of its generating assets to that company in about 18 months. But APS decides to ignore PWEC and add 1,800 megawatts of capacity in-house, as it were.

Would the state's coven of merchant generators not come unglued and demand an investigation of what APS was doing? Would the Commission itself not say what's up? After all, why would APS finance and build generation it would have to divest in almost no time?

Then, suppose divestiture goes forward at the end of 2002. Now, APS comes to the Commission and asks to recover the costs of transferring the new generation and its permits to PWEC, unwinding the financing, etc. Would APS not get laughed out of the Commission office?

The point is that regardless of whether APS was prevented by rule or regulation from building new generation, there was no rational reason under the prevailing circumstances to build it anywhere but at PWEC. Nevertheless, APS customers needed the power and they got it.

V. NEEDED: A REALISTIC RETURN ON EQUITY

Q. DOES AUIA HAVE A POSITION REGARDING THE STAFF'S RECOMMENDED RETURN ON EQUITY?

A. Yes. We believe that the recommendation for a 9 percent return on equity

(ROE) presented by Staff witness Joel Reiker is woefully inadequate and that it would place APS at the very bottom in authorized earnings for comparable electric utilities. As I will demonstrate shortly, the financial community has concluded that it is far below the norm in the electric industry.

Q. WHAT IS THE EFFECT ON REVENUES?

A. The short answer is that it is disastrous, especially in light of the sharply declining earnings performance of APS in 2002 and 2003. However, the revenue issue is complicated by the Staff's treatment of rate base.

According to the summary of the Staff's case provided by Ms. Jaress, the difference between the company's proposed ROE of 11.5 percent and the staff's recommendation of 9 percent is a reduction of nearly $75 million in the revenue requirement

However, the Staff proposes a rate base of $3.1 billion, reduced from the company's proposed rate base of $4.21 billion. This results primarily from eliminating the PWEC generating units from rate base. According to Ms. Jaress' testimony, this lowers the revenue requirement by nearly $106 million. Of course, the effect of the rate base reduction is calculated using Staff's recommended ROE. It would be greater if a higher ROE were applied.

Together, the combination of ROE and rate base recommendations proposed by Staff reduce the company's proposed revenue stream by about $180 million.

Q. HOW HAS THE FINANCIAL COMMUNITY RESPONDED TO STAFF'S RECEOMENDED ROE?

A. Very negatively. As I indicated earlier, there has been little detailed analysis from financial analysts, who hope that the Staff's recommendation will not be adopted. However, their published comments indicate that they regard the Staff's proposed ROE as the worst they have encountered recently. Here are some samples:

On Feb. 4, JP Morgan Equity Research asserted that the ACC Staff "set a more punitive return requirement than any other commission has implemented."

On Feb. 4, Merrill Lynch commented on the extreme nature of the Staff position and added, "For example, the 9% ROE would be the lowest we have ever seen allowed by any state."

On Feb. 4, Harris Nesbitt Gerard opined that the ROE recommendation appears "paltry in comparison with recent decisions in other states (which have ranged from 9.5%- 12%+)..."

On Feb. 4, Credit Suisse/First Boston said, "The 9% ROE recommendation appears low considering recent rate case decisions in Arizona (11%) and around the country. A lower interest rate environment can be argued for a rate below the requested 11.5%, but the proposed rate seems extreme considering PNW's solid reliability record, market growth, and low customer rates relative to history."

Q. DOES AUIA HAVE A RECOMMENDATION ON ROE?

A. Based on recent industry trends and the specific need to shore up APS' cash generation and earnings power, we would recommend an ROE between 10 and 11 percent applied to a rate base that includes all or most of the PWEC assets at book value.

Q. HOW DID THE STAFF ARRIVE AT SUCH A LOW RECOMMENDATION?

A. Mr. Reiker relies on the output of three finance models to arrive at his recommendation. It is essentially a combination of the results of a constant growth discounted cash flow (DCF) model (7.7%), a multi-stage DCF model (10.6%) and capital asset pricing model (CAPM). The average of the DCF findings (9.1%), combined with the CAPM result (8.9%), produces his ROE recommendation of 9 percent. Clearly, it is his specific manipulation of the components of the models that dictate the results.

Q. DO YOU HAVE SPECIFIC OBJECTIONS TO STAFF'S METHODOLOGY?

A. It doesn't serve any purpose for me to wade into the fray between dueling economists, but I have some serious concerns about Mr. Reiker's overall approach. He is inflexible; his assumptions and conclusions do not reflect the reality of the financial markets; and he misconstrues investor thinking. As a result, his recommendations do not provide regulated utilities with the opportunity to earn a fair rate of return as required by law.

Q. WHAT ARE YOUR CONCERNS ABOUT MODELING?

A. Mr. Reiker would have us believe that there is only one way to construct his models -- his way. Yet, there are numerous decision points where inputs can vary. In this case, for example, Mr. Reiker and Dr. Olson differ on their selection of sample utilities. Mr. Reiker chooses the less risky group, which results ultimately in a lower indicated ROE.

Also, in the DCF model, Mr. Reiker rejects Dr. Olson's use of 6-month average dividend yields as opposed to spot yields because the former tend to "smooth" the market and he opposes the use of analysts' forecasts on grounds that they are overly optimistic. In the market risk premium, Mr. Reiker argues against using corporate bond yields because they carry "default risk," which can be diversified, and he chooses a medium term risk-free asset, which nets a lower premium.

In estimating cost of capital, Mr. Reiker also will not entertain any consideration of currently authorized rates of return in the industry or of actual returns on equity being earned in the industry or of forecasts of ROE.

These choices reflect a pattern, which I have observed in three consecutive rate cases. In a recent water company case, there were 15 separate decision points in which Mr. Reiker differed with the company's cost of capital witness and in every instance, his choice tended to produce a lower cost of equity.

In AUIA's view, this approach is designed to produce the lowest possible cost of equity, regardless of the realities of the capital markets, and that is why today we see the financial community offering expressions of disbelief over the Staff's recommendation.

Q. DO YOU DIFFER WITH MR. REIKER ABOUT HOW INVESTORS VIEW "UNIQUE RISK?"

A. Yes. As Mr. Reiker describes at P. 6-7 of his direct testimony, his theoretical approach to investor expectations excludes any consideration of so-called "unique risk" or firm-specific risk. These are risks that arise from a company's particular situation, such as the quality of its management, its business plan or specific projects it may undertake.

Mr. Reiker asserts that the most prevalent measure of a firm's market risk is "beta," which measures the risk of an investment according to macroeconomic events that affect all businesses. He argues that unique risk isn't measured by beta, nor does it affect the cost of equity because it can be eliminated by shareholder diversification. Investors who choose not to diversify won't expect to be compensated for unique risk, according to Mr. Reiker.

I do not agree. Any investor who completely ignores what Mr. Reiker terms "unique risk" is going to experience severe disappointments, no matter how diversified his portfolio. I could recite a long list of companies engaged in electric generation, trading, gas transportation, telephone distribution, long distance, wireless communications, software development and semiconductor manufacturing that have fallen flat since 2000. If you were invested in those companies then, you were probably rich. If you are holding their stock today, along with California bonds, your portfolio may be six feet under water.

I would submit that much of the investment loss associated with those companies was the result of the market's failure to recognize and act on "unique" risks that were present in their business plans, their management and the regulatory regimes under which they operated.

Q. DO YOU BELIEVE THAT MR. REIKER IS CORRECT IN HIS BELIEF THAT INVESTORS WHO HOLD DIVERSIFIED PORTFOLIOS DO NOT CARE ABOUT UNIQUE RISK?

A. I think Mr. Reiker lacks experience as an equity investor. I know that Arizona utility companies and AUIA receive many inquires from analysts and investors about the probable effect of "unique" or specific risks, including the risk posed by regulatory decisions of this Commission. If Mr. Reiker were correct, we would not receive these sorts of inquiries. They would just look up the company's beta and assume that it has the same risks as other companies with the same beta.

The investors I deal with would not willingly accept losses due to company-specific risks simply because they own stock in Disney or Pepsi. I can attest that after Three Mile Island, an electric utility that was building a nuclear power plant was besieged by investors who were worried about the unique risk of that investment. Those considering investments in Arizona's regulated utilities also would not simply ignore the return on equity this Commission authorizes.

Q. DO YOU BELIEVE THAT FIRM-SPECIFIC RISK SHOULD BE WEIGHED IN ESTIMATING THE COST OF CAPITAL?

A. Yes, where it's appropriate. It is my understanding that in setting rates for utility service, the Commission must allow a utility, in addition to recovering its operating expenses, taxes and depreciation, an opportunity to earn a return that is equal to returns that are being earned on investments in other businesses that have corresponding risks.

This is known as the comparable earnings standard, and it has been in effect for decades. For example, in the *Bluefield Waterworks* case, the United States Supreme Court stated: "A public utility is entitled to such rates as will permit it to earn a return . . . equal to that generally being made at the same time and in the same general part of the country on investments and other business undertakings which are attended by corresponding risks and uncertainties.. " *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679, 692 (1923).

In another decision, *Hope Natural Gas*, the United States Supreme Court re-emphasized the rate of return principles stated in *Bluefield Waterworks:*

"The return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks." *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944).

In order to achieve comparable earnings, it is necessary to evaluate the firm-specific or unique risks associated with an investment in that particular firm. From the standpoint of a typical investor, I believe that Mr. Reiker's theory violates this standard by choosing to ignore firm-specific risks and relying instead on Value Line betas and the utilities' debt exposure as the sole determinants of risk.

Q. DOES AUIA AGREE WITH STAFF'S APPROACH TO CAPITAL STRUCTURE?

A. No, assuming that we understand it. Mr. Reiker apparently quarrels with Dr. Olson's proposed alternate capital structures, which are: 1) If the PWEC units are rate-based, the capital structure for APS should be 55% debt, 45% equity, and 2) If the units are not rate-based, the capital structure should revert to the actual ratios of 50% equity, 50% debt as of December 31, 2002, before the $500 million loan to PWEC was consummated.

As far as I can tell, Mr. Reiker argues that the capital structure should be what it was at the end of 2003 -- 55% debt, 45% equity, with the PWEC debt on the APS books -- regardless of whether the PWEC assets are rate-based.

From AUIA's perspective, the company's first alternate (55-45) may be somewhat illogical if the units are rate-based, but we view that as a concession by APS to help mitigate the rate effects of rate-basing.

The second alternate (50-50) makes eminent good sense if the units are not rate-based because the lower debt structure would alleviate some of the credit stress that APS will undoubtedly experience under an order that excludes rate-basing.

Further, we suspect that Mr. Reiker is being less than candid in his arguments about this alternative. It is likely that he is primarily concerned that the revenue requirement would be increased, even on such an anemic rate base, if 5 percent were added to the equity component of the capital structure.

VI. A FORTHRIGHT COMMISSION WOULD RESTORE THE WRITE-OFF

Q. WHAT IS THE WRITE-OFF THE COMPANY WANTS RESTORED?

A. In 1999, APS and a group of intervenors in the electric competition docket resolved their differences over the company's recovery of stranded costs and the mechanism for collecting them. It has been referred to since as the 1999 Settlement Agreement and the Commission approved it. As a part of the settlement, the company agreed to reduce its stranded cost claim by $183 million ($234 million present value) and it wrote off that amount from shareholder assets.

Q. WHAT ARE THE STAFF'S OBJECTIONS TO RESTORING THE WRITEOFF?

A. Let's be honest. The dominant reason for opposing the restoration of the write-off is that it would raise the company's revenue requirement and every scintilla of the Staff's testimony is designed to prevent that. However, Staff witness Lee Smith posed several arguments for opposing restoration. The key ones seem to be that the company is asking for retroactive ratemaking and that the adjustment would result in setting rates that exceed the company's costs.

Q. WHAT IS AUIA'S POSITION?

A. AUIA would argue that the Commission is morally obligated to make the company whole on this issue because it was a component of the Settlement Agreement, which has provided untold benefits to APS customers, but which was abrogated unilaterally by the Commission in the Track A decision. Restoring the write-off is no different from adding plant in service and does not constitute retroactive ratemaking.

Q. DOES MS. SMITH POSE OTHER OBJECTIONS TO RESTORATION?

A. Yes. She takes aim several times and misses. For example, she asserts that the company has not demonstrated that it has been harmed, but in the absence of the Settlement Agreement, the harm is going forward. She also notes that the write-off did not result in the company's revenues being reduced. That is pure sophistry because the company circumscribed its revenues with an overlay of annual rate decreases as a condition of the Settlement Agreement.

Ms. Smith also postulates that without the Settlement Agreement, APS' rates might have been reduced due to over-earning, which she claims is indicated in APS financial reports for 2000 and 2001 (significantly, not in 2002). We have no idea what relevance this has to the issue of restoring the write-off, but we offer the following observations:

First, revenues in 2000 and 2001 were heavily inflated by the favorable margins experienced in marketing and trading (M&T) during the western energy crisis. It is at least debatable whether those revenues and the associated costs would have been recognized in a rate case because they were not generated by resources under regulation.

Second, the reports cited by Ms. Smith undoubtedly understate plant in service, which was not yet in rate base. In other words, Ms. Smith's observations are pure, untested speculation.

Third, when the Commission defended a challenge to the electric competition rules in the appellate courts, it swore that APS' rates were just and reasonable.

Having said all of that, I would describe AUIA's position on the write-off as somewhat ambivalent. In ranking the issues on which Staff has demonstrated complete negativity, I would put a reasonable return on equity, rate-basing the PWEC units and a workable purchased power and fuel adjustment clause ahead of restoring the write-off in terms of maintaining the company's financial integrity.

VII. <u>APS AND ITS CUSTOMERS SHOULD BE INSULATED FROM EXTREME FUEL PRICES</u>

Q. DOES THE STAFF SUPPORT OR OPPOSE A PPFAC TARIFF?

A. Yes.

Q. WOULD YOU EXPLAIN STAFF'S POSITION, AS YOU UNDERSTAND IT?

A. Staff's witness on fuel costs, Douglas Smith, acknowledges that natural gas prices have been volatile and are likely to continue that way. He appears to favor the use of a fuel adjustment mechanism as long as it is broad enough to capture all of APS' fuel options and thus encourages the company to make economical choices. Mr. Smith advocates a more complicated fuel adjustment mechanism than the company has proposed.

However, Mr. Smith is also concerned about a potential "imbalance" in fuel cost collections and Ms. Jaress asserts that Staff will not support a PPFAC unless that concern is resolved.

Q. WHAT IS THE NATURE OF THE SUGGESTED IMBALANCE?

A. As we understand it, Mr. Smith believes that if a PPFAC is implemented for a utility, like APS, that has a rapidly growing customer base, the company could over-collect the fixed costs in its base fuel cost as load grows in the future and kWh sales increase.

Q. DOES AUIA HAVE A POSITION ON THIS ISSUE?

A. AUIA has no particular expertise in the intricacies of fuel adjustors, but we question the emphasis on this problem. It seems to us that the same risk applies to any fixed costs that are built into rates in a situation in which customer loads are constantly increasing. We have no preference for the various approaches to the PPFAC that are proposed in Staff and company testimony, but we think it is essential for the Commission to approve an appropriate mechanism.

Q. WHY IS THAT SO ESSENTIAL?

A. In Docket E-01345A-02-0403, the Staff cited as an advantage of a PPFAC that a correctly operating adjustor will reduce the volatility of a utility's earnings and that risk reduction can be reflected in the cost of equity capital and, ultimately, lower rates.

Conversely, if APS is not granted a workable PPFAC, the financial community will conclude that the company's earnings will be unreasonably exposed to volatile fuel prices and market risks that are inappropriate for a regulated utility. If they are right, APS could sink rapidly to unacceptable levels of cash flow and earnings.

VIII APS DID NOT VIOLATE THE ELECTRIC COMPETITION RULES

Q. DID STAFF REACH A CONCLUSION ABOUT THE INQUIRY INTO APS' BEHAVIOR THAT WAS ORDERED IN THE FINANCING DOCKET?

A. Yes. Ms. Jaress conducted the inquiry and Staff's findings are contained in her direct testimony. In brief, she concludes that APS violated "the spirit, if not the letter," of the electric competition rules. However, she concedes at the same time that APS customers were not harmed in any way.

Q. IS THAT THE END OF THE MATTER?

A. It should be, especially since the divestiture rules, which are the root of this issue, have been declared illegal by the courts. But Ms. Jaress takes up 20 pages of testimony on this matter with the effect of splashing mud on the company's case and discrediting the executives of APS and Pinnacle West.

Ms. Jaress asks and answers six separate questions about this issue and I will address each of them. But first, I would like to give this matter some perspective that is not encumbered with revisionist history.

In 2001, when the infamous rating agency presentations were made, PWEC had every right to assume the following:

- That all of APS' portfolio of generation would be transferred to PWEC at the end of 2002.

- That the combined APS/PWEC portfolio of nuclear, coal and gas-fired generation would be more economical for APS than any other combination of available generation in the region.

• That under the electric competition rules, PWEC's output would be required to serve most of the APS load, through bidding and bilateral contract, at least until the utility's load growth exceeded the capacity of the portfolio.

In 2001, PWEC had a fiduciary responsibility to obtain the best credit rating it could as a stand-alone wholesale generator so that it would be competitive in the marketplace and also so that it would not damage the credit of its affiliates, Pinnacle West and APS. But there was more in play than PWEC's credit.

At that time there was little concern that merchant generators would not be profitable. After all, you could sell a kilowatt-hour in California for 10 times what it cost to produce. And there was a gaping hole in the Commission's competition rules. Distribution utilities were mandated to meet their customers' needs, but wholesale generators were not. In other words, once PWEC controlled the APS generation, it could have sold its output into California and APS could have been left to the mercy of the wholesale market.

Thus, it was just as important to show the rating agencies that APS' needs were covered as it was to prove up PWEC's credit. Otherwise, APS might have been put on negative credit watch.

Against this backdrop, it was perfectly logical for PWEC to present the rating agencies with a proposed full requirements contract that accounted for APS' needs and PWEC's output.

Q. **WILL YOU RESPOND TO MS. JARESS' SPECIFIC FINDINGS?**

A. Yes, in the order in which she presents them.

1. Ms. Jaress concluded that it was unfair for PWEC to present contracts to rating agencies because it would indicate that other merchant plants would not be selling to APS and that would affect their financing and credit rating. Apart from the fact that this conclusion is purely speculative, it is based on the irrational assumption that the fate of some 15,000 MW of merchant generation depended on the disposition of a small component of APS load.

2. Ms. Jaress determined that the existence of a <u>proposed</u> contract between APS and PWEC was anti-competitive and, if it had been consummated, it would have diminished or eliminated competition in the long run. This is a curious finding since bilateral contracts were allowed by the rules and also in light of subsequent events, including the Commission's finding in the Track A proceeding that the wholesale market didn't really exist and the Track B order, which restricted competitive solicitation to APS' unmet incremental needs. When the company filed its proposed variance and waiver in October 2001, the contract at issue here became moot. The Commission initiated every action affecting competition from that time forward.

3. Here, Ms. Jaress sets up a straw man based on the assumption that the PWEC plants were built "only to serve APS." We are mired in serious semantics here. Other than reliability must-run units, virtually no plants that serve intermediate or base loads are devoted solely to serving native customers when they come on line. They usually bring excess capacity to the system and serve a combination of external and native loads until their output is fully needed for native load customers. Otherwise, there would be blackouts before they became operational. Even when they are mature, some plants will have excess capacity for sale because their marginal costs don't

always fit economic dispatch criteria. The out-of-context statements of PWCC and APS executives do not prove Ms. Jaress' case.

4. Ms. Jaress concludes that the electric competition rules and the code of conduct required of APS prohibited the company from engaging in certain competitive activities but not from constructing new generation. The implication is that APS could or should have built the PWEC units and, ergo, they were merchant plants. I will not stir this mush further except to say that AUIA disagrees with Ms. Jaress' conclusion and continues to assert that it would have made no sense to build these units at APS under the prevailing circumstances.

5. Ms. Jaress finds that an APS application for an air quality permit for the PWEC units did not create a significant benefit for PWEC. We agree.

6. Ms. Jaress concludes that APS gave PWEC a "slight" competitive advantage by transferring land for power plant locations to PWEC at book value rather than market value. The electric competition rules permitted the transfer of generation assets to an affiliate at book value. If the land in question was held by APS for power plant construction, it was a generation asset and we fail to see that APS committed any offense at all under the rules.

IX. CONCLUSION

Q. CAN YOU SUMMARIZE YOUR TESTIMONY?

A. AUIA's rebuttal testimony has focused almost entirely on the recommendations made by the ACC Staff, to the exclusion of every other point of view presented in this proceeding. The Staff's recommendation as a whole is so irrational and punitive in light of APS' record of performance that it has set off alarms throughout the financial community.

Based in large part on the reactions of the financial analysts and the rating agencies, AUIA believes that if any decision were reached in this case that resulted in a net revenue decrease for APS, the stock of Pinnacle West Capital Corporation would be trashed in the financial markets. We also believe that if 1,800 megawatts and nearly $1 billion of generating assets were excluded from rate base, it is highly probable that the credit ratings of PWCC and APS would be lowered.

Moreover, such a decision would brand the Arizona regulatory environment as unstable and irrational, a stigma that, for years to come, would follow every company under Commission jurisdiction that has to raise money from public sources.

AUIA believes that the arguments over the original purpose of the PWEC units have become moot by virtue of the fact that the Arizona Court of Appeals has declared unconstitutional the Commission's divestiture order, which is at the root of the controversy. The only appropriate questions affecting rate-basing are whether the decision to build was prudent and whether the units are used and useful.

The fair and honorable thing for this Commission to do regarding the $234 million write-off is to restore it to rate base These are shareholder assets that were sacrificed as part of a negotiated settlement agreement, which the Commission approved and then unilaterally nullified in large part.

Staff's recommended ROE has been described by some financial analysts as the lowest they have ever seen and that should give the Commission pause. A more rate of return would be between 10% and 11%.

Finally, the Commission should shield APS and its customers from the volatility of fuel and purchased power prices by adopting a workable PPFAC in this proceeding.

Q. DOES THAT CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.