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COMMISSIONERS

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

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

Docket No. E-01345A-03-0437

JOINT CLOSING BRIEF SUBMITTED BY THE SIGNATORIES TO THE PROPOSED SETTLEMENT AGREEMENT

I. INTRODUCTION.

The Proposed Settlement by more than twenty parties to this proceeding ("Parties") is a remarkable, even unique achievement. Included in these Parties are representatives of Arizona Public Service Company's ("APS" or "Company") customers, environmental and renewable energy/energy efficiency advocates, retail and wholesale competitors of APS, and of course, Commission Staff. And as was noted in the settlement testimony of nearly all of the Parties, the final product of their many, many days, weeks and months of effort, the Proposed Settlement, is a finely-balanced document, with each provision of vital concern to one or more Parties. Similarly, each provision represents a compromise by one or more Parties of their litigation position.

That the Proposed Settlement does not reflect all of the litigation positions taken by any of the Parties should come as no surprise. This was a settlement - not a surrender - by the Parties, and the inherent nature of all settlements is that of compromise. As was noted by APS witness Wheeler:

> Arizona law is full of repeated statements supporting the use of negotiated settlement rather than litigation to solve disputes. The more complex the dispute, the more likely it is that the parties most affected can better negotiate than litigate a resolution that has broad acceptance as being a fair solution to difficult problems. Indeed, the entire legislative process, with which several of

> the Commissioners are quite familiar, is essentially one of negotiation, debate and compromise.

(Wheeler Settlement Direct Test., Ex. APS-1SD at 4).[1] Interestingly, our Supreme Court considers ratemaking itself to be such a legislative act. *Arizona Corporation Commission v. Superior Court*, 107 Ariz. 24, 480 P.2d 988 (1971).

The Parties are confident that the record in this matter, which was developed after eight long days of evidentiary hearings and the presentation to the Commission of some 64 witnesses' testimony and over 150 exhibits, many of which were specifically requested by the Commissioners themselves, clearly supports each of the provisions of the Proposed Settlement. The Parties are equally confident that the Commission will recognize the complexity of the compromises reached and the mutual interdependence of each component of the Settlement Agreement.[2] The Parties therefore request that the Commission approve the Proposed Settlement without modification.

The Parties would further request that the Commission act promptly on the Proposed Settlement. Several key provisions of the Proposed Settlement require that actions be taken during 2005, which is now upon us. These include:

> (1) a commitment by APS to spend at least $10,000,000 during 2005 on Commission-approved energy efficiency DSM programs;
>
> (2) a comprehensive "all sources" RFP seeking at least 1000 MW of long-term resources needed to serve APS customers; and
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> (3) a special procurement seeking at least a ten-fold increase in renewable energy resources for APS customers.

Early action by the Commission on the Proposed Settlement will increase the potential for implementation of the above provisions in a timely and cost-effective manner.

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[1] *See, e.g., United Bank of Arizona v. Sun Valley Door & Supply, Inc.*, 149 Ariz. 64, 716 P.2d 433 (App. 1986); and also *Dansby v. Buck*, 92 Ariz. 1, 373 P.2d 1 (1962) as Arizona authorities indicating that it is the public policy of this state to encourage and support settlement.

[2] See paragraphs 136, 138, 139, and 143 of the proposed agreement.

II. THE COMMISSION SHOULD APPROVE THE $75.5 MILLION RATE INCREASE PROPOSED IN THE AGREEMENT.

The $75.5 million proposed in the Proposed Settlement comprises a modest increase in base rates of $67.6 million and a CRCC surcharge of $7.9 million. (Johnson Settlement Test., Ex. S-14 at 7). Although this result represents an increase over the litigation positions of Staff, RUCO, and various other parties, it also represents a $100 million reduction to APS' original rate case request. Id.

The litigation testimony in this case presented vastly different revenue requirement proposals, ranging from Staff's proposed $142 million rate reduction to APS' proposed $175 million increase. (Jaress, Tr. at 689). The Proposed Settlement's $75.5 million revenue requirement falls within the range of recommendations set forth in the parties' various litigation positions. More importantly, however, the proposed revenue requirement balances the equities presented by this case to allow APS needed additional revenues to provide reliable service and to afford ratepayers just and reasonable rates. (Johnson Direct Test., Ex. S-14 at 7-8). Indeed, as is discussed in later portions of this Joint Brief, all the major rating agencies considered the rate increase very modest and looked largely to other aspects of the Agreement to justify whatever positive reaction they expressed concerning the Proposed Settlement. (Robinson Settlement Direct Test., Ex. APS-2SD at 5-6; Fetter Settlement Direct Test., Ex. APS-4SD at 13-18).

Although some of the Parties attempted to address the composition of the proposed $75.5 million revenue requirement, it is important to emphasize that it is a negotiated number. (Johnson, Tr. at 793-95). Accordingly, it is not possible to identify every adjustment contained therein. As noted by Staff Witness Jaress and APS Witness Robinson, the proposed revenue requirement contains between $17-18 million that cannot be traced to any specific adjustment. (Jaress, Tr. at 791; Robinson, Tr. at 800-01). This "black-boxing" allowed the Parties to bypass issues on which they may never have reached agreement and focus instead upon arriving at a reasonable overall resolution.

Some aspects of the revenue requirement must be specifically identified in order to comply with certain legal and/or regulatory requirements. For example, A.A.C. R14-2-102.C.4 prohibits public service corporations from changing their depreciation rates without express approval from the Commission. *See also* A.R.S § 40-222. For this reason, the Proposed Settlement sets forth specific findings related to depreciation and specifically calculates the resulting depreciation rates.

Nuclear decommissioning is another area that requires specific findings. Since Decision No. 55931 (April 1, 1988), the Commission has treated decommissioning expense as a specialized component of depreciation. Id. at 39-44. Thus, the previous paragraph's discussion is equally applicable here. In addition, funding levels for Palo Verde's decommissioning and the funding thereof are under the oversight of the Nuclear Regulatory Commission. These funding levels are also governed by the Palo Verde participation agreement and thus also concern other Palo Verde participants. Finally, the ability of APS to maintain favorable federal income tax treatment of both its current decommissioning contributions and of its qualified decommissioning trusts (a goal endorsed by the Commission in Decision No. 55931 at page 44) is dependent upon explicit Commission approval in rates of the amount of APS' decommissioning expense. Accordingly, this issue requires an identifiable resolution, and it is for this reason that the Proposed Settlement contains specific schedules related to nuclear decommissioning.

Some issues, such as the agreed-upon rate base value for the PWEC assets, have precedential value and are therefore specifically identified. (Tr. at 690-91). Finally, the Proposed Settlement sets forth specific cost of capital findings, which are helpful when determining APS' fair value rate base and fair value rate of return, as required by Arizona law.

In summary, the proposed $75.5 million revenue requirement contains a mixture of identifiable adjustments and "black box" issues. The Parties believe that the Agreement strikes an appropriate balance, subsuming certain issues that may have acted as barriers to achieving overall resolution, while also providing specific resolutions where necessary in order to comply with legal requirements, regulatory requirements, or to meet the specific needs of various parties.

The Parties believe that the proposed revenue requirement, when considered in the context of the Agreement as a whole, appropriately balances the interests of the Company, its ratepayers, and the public. The Parties therefore urge the Commission to approve the Proposed Settlement Agreement.

III. WHEN EVALUATING THE REVENUE REQUIREMENT, THE COMMISSION SHOULD ALSO CONSIDER THE LONG-TERM BENEFITS AND THE NON-MONETARY BENEFITS OF THE AGREEMENT.

When evaluating the Proposed Settlement, the Commission may be tempted to concentrate on the resulting rate impact on customers. Although this is certainly a relevant inquiry, so is the need to maintain the Company's financial integrity. Moreover, the parties believe that the Agreement also presents certain long-term and non-monetary benefits, many of which are difficult to quantify. (Higgins, Tr. at 736).

First, there are substantial benefits to all parties from resolving the disputes related to the PWEC assets. APS benefits because it will be able to rate base the PWEC units and receive needed regulatory certainty, the merchants will benefit because they will have specific competitive opportunities, and the ratepayers will benefit because they will pay for the PWEC units at a reduced value. In fact, the reduction in value of the PWEC units is a permanent rate base reduction that will benefit APS' customers for many years to come. (Jaress, Tr. at 691; Higgins, Tr. at 704, 736).

The Proposed Settlement also provides for significant additional DSM spending. This increase in DSM spending should in the long term reduce APS' need for additional generation, which will mean savings for ratepayers. (Jaress, Tr. at 691). The Agreement also includes a special RFP for renewables, which is a positive step toward providing long-term improvements to the environment and promoting resource diversity. Id. Finally, the Agreement provides for increased discounts for qualifying low income customers, thereby resulting in rate decreases for some of these customers. (Johnson, Tr. at 785).

To summarize, the Proposed Settlement's most significant merits may be overlooked if one focuses exclusively upon any single issue. It is true that the proposed revenue requirement is a negotiated number, that it represents compromise on behalf of many of the Parties, and that there are aspects of it that cannot be traced to specific accounting adjustments. These factors, however, are present in most--if not all--settlement agreements. The more important inquiry is whether, in light of the record as a whole, the Agreement will promote the public interest. The answer to that question is yes, because the Agreement is designed to ensure that APS will have the revenues necessary to provide reliable service and that ratepayers will be afforded just and reasonable rates. For these reasons, the Parties request that the Commission approve the Proposed Settlement. (Diaz Cortez, Tr. at 742-44).

IV. THE ACQUISITION AND RATEBASING OF THE PWEC GENERATING UNITS BY APS UNDER THE SPECIFIC TERMS SET FORTH IN THE PROPOSED SETTLEMENT ARE IN THE PUBLIC INTEREST.

A. *Introduction.*

Section II of the Proposed Settlement addresses the treatment of the PWEC Arizona generation, specifically West Phoenix CC-4, West Phoenix CC-5, Saguaro CT-3 and Redhawk Units 1 and 2. They are to be acquired by APS at their book value as of the date of acquisition. That book value will then be adjusted downward by $148,000,000. Such an adjustment, when applied to the December 31, 2004 book value of the PWEC assets, produced an original cost rate base value of $700,000,000 for purposes of the Proposed Settlement and the instant rate case proceeding. (Proposed Settlement at ¶ 7). This is in contrast to the June 30, 2004 valuation requested in the Company's rate application of $889,237,000. (Application, Ex. APS-1, Schedule B-2, at 1).

The lower asset value for the PWEC units agreed to in the Proposed Settlement is just part of the story. The Proposed Settlement adopts, for purposes of this rate case, significantly longer service lives for the PWEC assets than proposed in the Company's application (Proposed Settlement at Section V). A longer expected service life reduces annual depreciation expense in the Company's cost-of-service. The rate of return called for in the Proposed Settlement (Section III), which is applied to the reduced rate base value, is also lower than that requested by APS. (Robinson Settlement Direct Test., Ex. APS-2SD at 8; Fetter Settlement Direct Test., Ex. APS-4SD at 12-13).

To better promote retail direct access, APS also agreed to provisions in Section II sought by several parties, including its retail competitors and representatives of its larger general service customers. These include an agreement not to seek any future stranded cost recovery potentially associated with the PWEC assets (Proposed Settlement at ¶ 8), even though the potential for such stranded costs is increased by the lengthened service lives assumed for the PWEC generating assets, and assurance that the cost of the PWEC assets will be recovered through unbundled generation rates (except to the extent such costs relate to ancillary services classified as transmission-related), thus insulating future APS direct access customers from these costs. (Proposed Settlement at ¶ 6).

By their support of the Proposed Settlement, some 21 parties to this proceeding (including all the parties that originally submitted testimony questioning or opposing the Company's ratebasing request) now affirmatively support the acquisition and ratebasing of the PWEC generating units under the terms of the Proposed Settlement. Even the one party actively opposing certain narrow portions of the Proposed Settlement, the ACA, is not opposing this part of the Proposed Settlement. (Murphy, Tr. at 1494.)[3]

B. Record Evidence in Support of Section II.

1. Prudence of decision to build the PWEC units and whether they will be "used and useful" in providing service to APS customers.

These are the criteria normally used by the Commission to determine whether a newly-constructed generating plant will be included in the Company's rate base. (Wheeler Direct Test., Ex. APS-2 at 13; Hieronymus Direct Test., Ex. APS-8 at 11; Wheeler Rebuttal Test., Ex. APS-2R at 22-25). And as indicated by AECC witness Higgins, if the Commission found that the acquisition is prudent and the plant is used and useful, the generation plant ordinarily would be rate-based at its full cost. (Higgins, Tr. at 703).

In its Direct Testimony, APS presented evidence as to the resource planning process that resulted in the decision to construct the PWEC generation as well as the overall reasonableness of the as-constructed cost of the generation. (Bhatti Direct Test., Ex. APS-7 at 24-72). APS further described how the PWEC units had provided and would continue to provide needed and economic generation for the benefit of APS customers. Id. at 8-23. Thus, the PWEC units meet the traditional standard of "used and useful."

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[3] Under Paragraph 9 of the Proposed Settlement, APS can also represent to the Federal Energy Regulatory Commission ("FERC") that the Parties support the Company's acquisition of the PWEC Assets as set forth in the Proposed Settlement. At the time the Proposed Settlement was signed, the Parties believed FERC approval of the acquisition would be required, and Paragraphs 9, 11, 12 and 13 reflect that belief. Subsequently, FERC issued a decision [*In Re Perryville Energy Partners, L.L.C.* (FERC October 6, 2004)] that indicated that FERC did not have jurisdiction over the acquisition of power plants by a regulated utility under certain circumstances, which circumstances may be present in the case of the transfer of the PWEC Assets to APS.

2. Market value of the PWEC units.

Although APS believed that the market value of the PWEC assets was irrelevant to the issue of rate basing the PWEC units, (Wheeler Rebuttal Test., Ex. APS-2R at 21-22, 38; Wheeler, Tr. at 330-31), clearly other Parties to the Proposed Settlement disagreed, and thus APS presented considerable evidence on this issue in its rebuttal case. As is discussed in the Rebuttal Testimony of APS witnesses Wheeler, Bhatti and Hieronymus, there are several methods that have been used to determine the "going forward" or "market" value of assets, including utility assets. (Wheeler Rebuttal Test., Ex. APS-2R at 26-30; Bhatti Rebuttal Test., Ex. APS-6R at 19-20; Hieronymus Rebuttal Test., Ex. APS-13R at 37-38). These include a capitalized value of future cash flows anticipated to be produced from the asset, the so-called "discounted cash flow" or "DCF" method. There is also reproduction cost, replacement cost and "comparable sales". Each method has its strengths and weaknesses, and more than a little subjectivity in their application.

In any event, APS witness Bhatti testified that the DCF valuation of the PWEC assets was at least over $950,000,000 (using APS-proposed cost of capital) and possibly as high as nearly $2,000,000,000 (using Staff-proposed cost of capital). (Bhatti Rebuttal Test., Ex. APS-6R at 5, 9). This analysis used both computer-simulations of future market revenues generated by the Company's GEMAPS modeling and actual long-term prices bid into the Company's 2003 RFP by non-affiliated suppliers. It also reflected the estimated value of the APS/Track B contract to APS customers in 2005-2006.

The reproduction and replacement cost analyses presented in Mr. Bhatti's Rebuttal Testimony. Id. at 26-43 indicate varying degrees of relative advantage to APS customers from the ratebasing of the PWEC units. For example, replacing the PWEC units entirely from the wholesale market at spot prices would cost, in present value terms analogous to the PWEC assets' rate base value, nearly $2,700,000,000. Id. at 7. Several of the "new build" scenarios produced values comparable to the PWEC assets using the Company's requested cost of capital. Id. at 28-29. However, once you factor in the $148,000,000 write-down, the lower cost of capital and lower depreciation, there is simply no comparable value to the PWEC assets.

Although "comparable sales" is the trickiest of the valuation methods, in that there is seldom a sale of a generating plant that is entirely "comparable" to another, with every seller and buyer having unique circumstances that affect the comparative value of the generating asset (Wheeler Rebuttal Test., Ex. APS-2R at 28; Bhatti Rebuttal Test., Ex. APS-6R at 20; Hieronymus Rebuttal Test., Ex. APS-13R at 37-38). APS witness Hieronymus presented just such a study. Using five roughly comparable sales for which pricing data is available, he determined that the rate base value originally proposed by APS for the PWEC assets was less than any of these other sales. (Hieronymus Rebuttal Test., Ex. APS-13R at 42). Needless to say, with the $148,000,000 write-down required by the Proposed Settlement, the relative value of the PWEC assets to APS customers is enhanced by an equal amount.

During the course of hearings on the Proposed Settlement, Commissioner Gleason asked questions concerning the Desert Basin sale to Salt River Project (one of the sales used in Dr. Hieronymus' study), as well as the Sundance sale to APS and the acquisition by Tucson Electric Power Company ("TEP") of the partially-constructed Luna unit. (Gleason, Tr. at 697-98). The Desert Basin sale clearly was for a price well above even the undiscounted rate base value proposed in APS' initial Application. (Hieronymus Rebuttal Test., Ex. APS-13R at 42). And, neither of these latter two transactions supports a lower value for the PWEC assets. Sundance is a set of simple-cycle combustion turbines. They generally operate only during peak periods and although they have lower capital costs than most of the PWEC units (Saguaro CT-3 is also a simple-cycle plant), they have much higher per MWH operating costs. Indeed, Mr. Bhatti testified that: "The binding asset sales finally offered [in the 2003-2004 RFP that resulted in the Sundance sale] were not comparable either in size or type of unit with the PWEC assets and were, in any event, <u>more costly than rate-basing the PWEC units</u>." (Bhatti Rebuttal Test., Ex. APS-6R at 39 (emphasis supplied)). This conclusion would only be further strengthened by the subsequent reduction in the PWEC assets' rate base value from the nearly $900,000,000 used by Mr. Bhatti to the Proposed Settlement's value of just $700,000,000. Luna is still under construction, and the fact that Duke was willing to write-off significant project development costs in its transaction with TEP and two other entities tells us little about its final costs in 2006 (the date estimated for completion of Luna in TEP's press release of November 12, 2004).

Moreover, neither Luna, nor for that matter the other generating units mentioned by Commissioner Gleason and those used in Dr. Hieronymus' study, can provide in-Valley resources comparable to the West Phoenix units owned by PWEC.

In sum, no party to this proceeding presented evidence that the market value of the PWEC assets was less than the $700,000,000 figure adopted by the Proposed Settlement. The Company's rebuttal case indicates a value for these plants that is much in excess of $700,000,000.

3. Operational advantages to acquiring the PWEC units.

In its rebuttal case, APS presented evidence that the ability to jointly dispatch the PWEC generation with APS' existing resources produced significant operating economies above and beyond the "stand alone" analyses of market value conducted by APS witnesses Bhatti and Hieronymus. These economies were estimated at $14,700,000 for 2005 alone (Davis Rebuttal Test., Ex. APS-1R at 24-25), and would primarily flow through to APS customers via the proposed PSA.

4. Wall Street Implications.

As noted in several of the witnesses' Settlement Testimonies, the reaction of the financial community to the Proposed Settlement, although generally favorable, was not overly enthusiastic. (Fetter Settlement Test., Ex. APS-4SD at 13-18). And to the extent that reaction was positive, the rate basing of the PWEC assets, along with the fuel and purchased power rate adjustment mechanism, were critical elements:

> The agreement, <u>most significantly</u>, would allow the utility [APS] to rate-base 1,790 MW of merchant capacity at a value of $700 million, net of a $148 million disallowance, owned by unregulated affiliate [PWEC] …
>
> *   *   *
>
> Also, <u>very significantly</u>, the settlement calls for the establishment of a fuel adjustment mechanism, which would include a sharing mechanism with ratepayers and be reset annually to track future fuel and purchased power expenses for subsequent recovery.

Standard & Poor's "Research: Arizona Public Service's Proposed Rate Settlement is Reasonably Constructive," August 20, 2004 (emphasis added). (Brandt Rebuttal Test., Ex. APS-3R at 4-5).

V. THE REQUIREMENTS IMPOSED BY THE PROPOSED SETTLEMENT FOR COMPETITIVE PROCUREMENT OF POWER ARE IN THE PUBLIC INTEREST.

A. Introduction.

Section IX of the Proposed Settlement addresses the process APS will follow to procure long-term resources in the future. Paragraph 74 of the Proposed Settlement imposes a self-build moratorium that precludes APS from building any new generation for approximately ten years (the in-service date for any new generation must be on or after January 1, 2015). By self-build, the Proposed Settlement refers to the ability of APS to construct new regulated generation. It does not preclude APS from acquiring existing generation or from negotiating long-term PPAs with either merchant generators or other generation-owning utilities. (Proposed Settlement at ¶ 77). This self-build moratorium is subject to the ability of APS to seek express authorization from the Commission to self-build prior to 2015, if APS can make the necessary showing that an exception is warranted. In place of the self-build option, Paragraph 78 of the Proposed Settlement requires APS to issue a Request for Proposals ("RFP") no later than the end of 2005 seeking long-term future resources of not less than 1000 MW for 2007 and beyond. Neither PWEC nor any other APS affiliate will be permitted to participate in this RFP. (Proposed Settlement at ¶ 78(b)).

Section IX of the Proposed Settlement also includes the following provisions concerning the power procurement process:

- The self-build moratorium does not preclude APS from acquiring (1) generation from a non-affiliate, (2) temporary generation needed for system reliability, (3) distributed generation less than 50 MW per location, (4) renewable resources, or (5) the up-rating of existing APS generation. (Proposed Settlement at ¶ 74).
- APS retains its existing obligation to acquire necessary generating resources in order to serve its customers. Id. at ¶ 76.
- If PWEC or any other APS affiliate participates in any competitive solicitation for long-term resources conducted by APS, an

independent monitor appointed by the Commission or its Staff will be required. Id. at ¶ 78(b).

- Renewable resources, distributed generation and DSM will be invited to compete in any competitive solicitation conducted by APS and will be evaluated in a manner consistent with the evaluation of all other bids. Id. at ¶ 78(d).
- Commission Staff will conduct a series of workshops, with the potential for eventual rulemaking, on power procurement issues. Id. at ¶ 79.
- Except to the extent modified by the terms of the Proposed Settlement, the Secondary Procurement Protocol will continue to apply to APS.[4] Id. at ¶ 80.

B. Development of a Robust Competitive Wholesale Market.

Section IX of the Proposed Settlement "is obviously at the core of the settlement's wholesale competition provisions" and provides the basis for gaining the support of the Proposed Settlement from many in the Arizona merchant power community, including the Arizona Competitive Power Alliance. (Wheeler Settlement Direct Test., Ex. APS-1SD at 24). The competitive procurement provisions in Section IX are consistent with the Commission's commitment to wholesale competition, as expressed in its Track A and Track B orders:

> We believe that requiring some power to be purchased through the competitive procurement process developed in Track B will encourage a phase-in to competition, encourage the development of a robust wholesale market for generation, and obtain some of the benefits of the new Arizona generation resources, while at the same time protecting ratepayers. Decision No. 65154, "Track A Order," Docket No. E-00000A-02-0051 et al., at 30. [t]he goal of the competitive solicitation is to provide ratepayers with reliable power at the lowest cost while furthering the Commission's goal of encouraging the development of a vibrant wholesale generation market in Arizona," Decision No. 65743, "Final Track B Order," Docket No. E-00000A-02-0051 et al., at 16.

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[4] Specifically, this provision refers to the RFP concepts that are embodied in the Proposed Settlement, which are not otherwise required by the Secondary Procurement Protocol. (Wheeler, Tr. at 376.)

The self-build moratorium provides a strong signal that independent power production is expected to be an effective alternative to utility-constructed generation. The moratorium, combined with Arizona's high growth rate, provides assurance to the merchant community that independent power will be an integral component in Arizona's future power infrastructure. (Patterson Settlement Direct Test., Ex. ACPA-3 at 5). With respect to the high growth rate, Schedule JED-4RB to APS Exhibit 1R shows the impact of the Company's retail load growth on its short position to the market. The Company's capacity deficit ranges from just over 100 MW in 2004 to over 1100 MW in 2006. Beginning in 2007, that deficit increases to well over 1400 MW, even after reflecting the inclusion of the PWEC assets. Thereafter, the deficit climbs by approximately 300 MW per year and, by the end of the decade, APS will be short to the market by 2420 MW. (Davis Rebuttal Test., Ex. APS-1R at 31).

Thus, even with the inclusion of the PWEC assets in APS' rate base, there will be a substantial opportunity for the merchant community to compete to supply a portion of APS' resource needs. Staff, for its part, expressed the view that inclusion of the self-build moratorium as part of the Proposed Settlement was essential "to counteract any perceived detriment to electric competition in Arizona that the transfer [of PWEC assets] could cause." (Jaress Settlement Test., Ex. S-15 at 6-7). As Staff observed, the self build moratorium and the required RFP represent "substantial commitments by APS to market based approaches to filling future capacity needs." (Rowell Settlement Report, Ex. S-16 at 5). These "pro-competitive provisions," as noted by Staff, provide a balance to the "potentially anti-competitive effects of rate basing" the PWEC assets and strike "an appropriate balance between market and non-market approaches." Id.

The 1000 megawatt RFP required in 2005 provides a degree of certainty as to the timing of an initial increment of APS' future needs that will be met from the wholesale market. Knowing the specific amount of capacity needed and the timing of its purchase allows the individual members of the merchant community to effectively plan for the most efficient way to meet that particular need. (Patterson Settlement Direct Test., Ex. ACPA-3 at 6). The RFP is not specific as to capacity or energy; it is simply a thousand megawatts that APS needs to buy. (Patterson, Tr. at 135). According to Mr. Robinson, APS did not believe it was necessary to specify that it would be buying both capacity and energy as part of that transaction since it does not have the ability to meet either its capacity or its energy requirements in 2007 without going to the market. (Robinson, Tr. at 471). Under the Proposed Settlement, APS has the ability to use the RFP to buy both energy and capacity. Id. It is important to the merchant community that the RFP requirements be flexible enough to permit either an offer of capacity or an offer of a long-term energy sale. (Patterson, Tr. at 475). According to Mr. Patterson, such flexible requirements would provide "a great signal to market participants that this is a competitive market where the Commission views merchant power providing capacity or energy as an acceptable option." Id. at 477. Or, as Mr. Higgins states it:

> If Arizona has set out the welcome mat for competitive generation, as I believe Arizona did, then I think it's important for the parties who come to Arizona and invest in Arizona to be able to expect that there is a range of outcomes that are possible for them. And, so, that range may include selling one's assets.

(Higgins, Tr. at 490). In the event APS seeks to build a plant, such a decision must be approved under a public interest standard (Wray, Tr. at 505), and the Commission would have an opportunity in that proceeding to evaluate the impact of such a decision on the competitive market. (Higgins, Tr. at 519).

C. Preservation of Necessary Flexibility to Ensure Reliable Service.

The Proposed Settlement includes elements that provide the necessary flexibility to ensure that APS will continue to provide reliable service. The self-build moratorium achieves this in two respects. First, the moratorium does not apply to the acquisition of temporary generation needed for system reliability. In the Company's view, these sorts of resources "are so reliability-related that APS believes it must retain the unfettered ability to construct such resources as and when appropriate." (Wheeler Settlement Direct Test., Ex. APS-1SD at 25). There are also exclusions to the self-build moratorium for renewable generation and small distributed generation (below 50 MW). These exclusions do not materially impact the overall generation market, and are necessary to further other public policy objectives. Id.

Second, the self-build moratorium includes protections in the event the wholesale market is unable to meet Arizona's growing power needs. If the Company's efforts to secure adequate and reasonably-priced long-term resources from the competitive wholesale market are unsuccessful, the

Commission may expressly authorize the Company to self-build prior to 2015 as to a particular demonstrated need. (Proposed Settlement at ¶¶ 74-75; Patterson Settlement Direct Test., Ex. ACPA-3 at 5). In order to obtain authorization from the Commission for relief from the self-build moratorium, APS must, among other things, describe its efforts to secure adequate and reasonably-priced long-term resources from the competitive wholesale market and explain why APS believes those efforts have been unsuccessful. (Proposed Settlement at ¶¶ 75(a), (b)). This requirement imposes a "pretty high hurdle" for relief from the moratorium, as Mr. Patterson observed (Patterson, Tr. at 292), and Mr. Wheeler agrees that the burden would be on the Company to provide the information demonstrating why relief was necessary. (Wheeler, Tr. at 294). The filing must also provide a comparison of the proposed self-build option with suitable alternatives from the competitive market for a comparable period of time. (Proposed Settlement at ¶ 75(e)).

The self-build moratorium provisions were carefully crafted to provide the merchant community with an opportunity to compete to supply a significant portion of APS' loads, while at the same time preserving the Company's ability to maintain reliable service for its growing loads in the event the competitive wholesale market is not able or willing to provide adequate power at reasonable prices. This strikes a reasonable balance between the competing stakeholders' interests. As stated by Mr. Wheeler:

> [W]e have put provisions in place to encourage the development of the competitive market and to get the benefits from it, but we also have another provision that indicates that there is an alternative if there is going to be market failure to protect you. So I think we have taken a measure that tries to reach a workable compromise between these two extremes.

(Wheeler, Tr. at 300). Mr. Higgins describes the settlement as providing "a clear message and a clear process that says we're going to give the merchants first crack at this without building in some potential evaluation bias, and at the same time if it doesn't come in at a reasonable cost, there is another way to go," which "appropriately balances" the divergent interests. (Higgins, Tr. at 302). The competitive procurement provisions of Section IX are in the public interest, and should be approved.

VI. THE PROPOSED SETTLEMENT PRODUCES BENEFITS FOR WHOLESALE COMPETITION.

The Commission has consistently expressed a commitment to "encouraging the development of a vibrant wholesale generation market in Arizona." (Decision No. 65743, "Final Track B Order," Docket No. E-00000A-02-0051 et al., at 16). APS' customers stand to benefit substantially from an efficient and well-functioning wholesale market in Arizona. Availability of wholesale providers gives APS important options for procuring resources to meet its growing load. As stated by Mr. Higgins, it is important for utilities "to have a balanced portfolio of resources at their command, and that includes access and use of the wholesale market and it includes plants in rate base." (Higgins, Tr. at 462). The Proposed Settlement produces benefits for wholesale competition that encourage the continued development of this wholesale market.

First, as described in Section V above, the Proposed Settlement imposes a self-build moratorium that precludes APS from building any new generation for approximately ten years. (Proposed Settlement at ¶ 74). In place of the self-build option, Paragraph 78 of the Proposed Settlement requires APS to issue a Request for Proposals ("RFP") within the next year seeking long-term future resources of not less than 1000 MW. Neither PWEC nor any other APS affiliate will be permitted to participate in this RFP. (Proposed Settlement at ¶ 78(b)). The self-build moratorium, coupled with the required competitive procurement process, provide strong encouragement to the development of independent power production in Arizona. Given the high growth rate in APS' loads (Davis Rebuttal Test., Ex. APS-1R at 31), the provisions of Section IX of the Proposed Settlement send a signal to the merchant community that independent power will be an integral component in Arizona's future power infrastructure. (Patterson Settlement Direct Test., Ex. ACPA-3 at 5). Moreover, the Proposed Settlement provides APS with the flexibility in the RFP either to use a PPA to buy energy or to buy capacity, a feature that is important to the merchant community. (Patterson, Tr. at 475).

Second, the Proposed Settlement benefits wholesale competition by providing some certainty as to the resource acquisition process. APS identified in its direct testimony its needs for clear, unambiguous answers to the following questions:

> 1. For whom does it have the obligation to plan to provide generation?
>
> 2. In meeting its obligation to provide adequate and reliable generation service, can APS build or acquire new utility-owned generation or is it limited to only seeking "Track B-like" PPAs?
>
> 3. Will any new generation constructed or acquired by APS to serve retail customers be regulated on a cost-of-service basis?

(Wheeler Settlement Direct Test., Ex. APS-1SD at 11-12). As described in Mr. Wheeler's settlement direct testimony, the Proposed Settlement addresses and resolves these issues. Id. at 12. APS has the obligation to plan to serve all customers within its designated service area, with recognition of the potential for direct access. (Proposed Settlement at ¶ 81). APS can build or acquire new utility-owned generation, subject to the requirements of Section IX of the Proposed Settlement. And the Proposed Settlement resolves the uncertainty regarding the inclusion of the PWEC assets in rate base.

Setting "the rules of the game" (Patterson, Tr. at 562) provides a significant benefit to wholesale competition. As described by Mr. Patterson:

> [W]e have been looking for certainty in that market for these years, and this settlement is much broader than the rate case itself.
>
> . . . .
>
> We have a solution to the self-build interpretation of Track A, we have a solution to when the next RFP is going to be taken care of. We have a solution to how can competitive power work in this market and at the same time allow APS to take the assets that they believe were built for the benefit of their customers and get the proper reimbursement for that.
>
> . . . .
>
> So the fact that we can now move on and have certainty and understand what the market is going to look like in the future is a tremendous benefit to us, it's a tremendous benefit to APS, and I think it is a huge benefit to ratepayers.

(Patterson, Tr. at 195-197). The Proposed Settlement, if approved, will advance the Commission's objective of "encouraging the development of a vibrant wholesale generation market in Arizona."

VII. BENEFITS OF THE PROPOSED SETTLEMENT FOR RETAIL COMPETITION.

Direct Access programs and customers were considered throughout the Settlement negotiations. (Chamberlin Settlement Direct Test., Ex. CNE/SEL-3 at 3; Wheeler Settlement Direct Test., Ex. APS-1SD at 21-24). As a result, the Proposed Settlement, if approved, will provide an opportunity for the development of a robust, competitive retail marketplace for electricity in the APS service area. During the hearing, in addition to support for the Proposed Settlement in the testimony of Ms. Tierney and Ms. Chamberlin of CNE and SEL, Mr. Johnson testifying for the Commission Staff stated that the Proposed Settlement would provide benefits from both retail and wholesale competition. (Johnson, Tr. at 119). Mr. Robinson, testifying for APS, said that the Company tried to assure that there would be no impediments to retail competition. (Robinson, Tr. at 577). Mr. Higgins, testifying for AECC, observed that the Proposed Settlement does accommodate and encourage retail access. (Higgins, Tr. at 578).

A number of provisions of the Proposed Settlement explicitly benefit Retail Competition:

- **Foregoing Stranded Cost Claims for PWEC Assets.** In Paragraph 8 of the Proposed Settlement, APS agrees to forgo any present or future stranded costs associated with the rate-basing of the PWEC assets. In the direct case, CNE/SE Witness Mr. Fulmer had stated that not addressing the potential for future stranded costs associated with the rate basing of the PWEC assets in this rate proceeding would have serious implications for Direct Access in Arizona, as the threat of new stranded costs would create an unfair and unnecessary risk for consumers considering competitive options. (Fulmer Direct Test., Ex. CNE/SEL-1 at 16). The ESP and large consumer witnesses testified that the foregoing of any stranded cost claims associated with the PWEC assets was critical to the development of flourishing retail markets (Chamberlin Settlement Direct Test., Ex. CNE/SEL-3 at 5) and will help prevent Direct Access service from being undercut by future stranded cost claims. (Higgins Settlement Direct Test., Ex. AECC/PD/FEA/K-1 at 19).

- **Adding West Phoenix CC-4 and CC-5 to Local Generation Assets.** In Paragraph 15 of the Proposed Settlement, as a part of rate basing the PWEC assets, West Phoenix CC-4 and CC-5 are added to the pool of "local generation assets" as defined by the AISA or successor protocols, which will allow generation from these assets to be made available to serve Direct Access load during must run conditions. (Chamberlin Settlement Direct Test., Ex. CNE/SEL-3 at 5). This provision ensures that Direct Access customers will have access to this generation during must run hours without being subject to pricing that is distorted by the exercise of localized market power during such hours. (Higgins Settlement Direct Test., Ex. AECC/PD/FEA/K-1 at 19).
- **Unbundled Rates With Generation At Cost.** A key component in fostering retail competition is the provision, in Paragraphs 113, 119 and 122 of the Proposed Settlement, for an unbundled rate structure with a generation component that is adequate to allow a customer to shop for alternative energy supply. (Chamberlin Settlement Direct Test., Ex. CNE/SEL-3 at 6). The Proposed Settlement provides this structure by unbundling APS rates and allocating competitive rate components such as generation and revenue cycle service in such a way that, to the extent possible and practical, cost recovery reflects cost causation so as not to distort the economics of shopping for customers who may wish to acquire Direct Access service. (Higgins Settlement Direct Test., Ex. AECC/PD/FEA/K-1 at 14; Tierney Settlement Direct Test., Ex. CNE/SEL-4 at 6).

- **Transmission Cost Adjustor**. In his direct testimony, CNE/SE Witness Mr. Fulmer cited the need for Direct Access customers to be treated in a non-discriminatory fashion with regard to transmission pricing. (Fulmer Direct Test., Ex. CNE/SEL-1 at 21). The Transmission Cost Adjustor described in Section XVI of the Proposed Settlement will help ensure that all customers will have equal costs for transmission whether they are on bundled utility service or taking service from a Direct Access service provider. (Chamberlin Settlement Direct Test., Ex. CNE/SEL-3 at 6).
- **DSM and EPS Benefits Shared.** All Direct Access customers and their suppliers will, pursuant to Paragraphs 53 and 65 of the Proposed Settlement, be explicitly entitled to benefit from the DSM and EPS programs which are funded via the public benefits charge and other surcharges. (Chamberlin Settlement Direct Test., Ex. CNE/SEL-3 at 6-7; Tierney Settlement Direct Test., Ex. CNE/SEL-4 at 6-7).
- **APS Planning Must Consider Direct Access Programs.** The Proposed Settlement recognizes the APS obligation to plan for and serve all customers – but ensures that APS will take into account ACC approved Direct Access programs and the potential for future Direct Access customers in its planning processes. Additionally, the Proposed Settlement does not prevent any party from seeking to amend APS' obligation to serve in the future. (Tierney Settlement Direct Test., Ex. CNE/SEL-4 at 5).
- **Metering and Billing Services.** Currently, Affected Utilities such as APS are not permitted by the Electric Competition Rules to offer competitive metering and billing services to the ESPs serving Direct Access customers. Paragraph 82 of the Proposed Settlement

explicitly calls for a review of this prohibition and calls for this review by the ECAG or some similar proceeding. Id. at 7.

- **RTO**. Paragraph 84 of the Proposed Settlement clarifies APS' ability to join a FERC approved RTO or an entity performing the functions of an RTO. The existence of an independent entity that administers the operation of the transmission system on a non-discriminatory basis for all participants is essential to developing and sustaining competitive retail markets. Id.
- **Wholesale Competition Benefits.** In addition to the strong retail competition benefits expressed above, the Wholesale Competition Benefits such as the Competitive Power Procurement Process (Section IX) and the Self-Build Moratorium (Section IX) are also beneficial to the retail marketplace by helping to develop a viable wholesale market from which retailers can obtain supply for their Direct Access customers. (Tierney Settlement Direct Test., Ex. CNE/SEL-4 at 4-5). This is discussed in more detail in other portions of this Joint Brief.

VIII. SECTION X OF THE PROPOSED SETTLEMENT WOULD RESOLVE REGULATORY ISSUES RAISED BY APS IN ITS DIRECT CASE IN A MANNER ACCEPTABLE TO THE PARTIES.

APS raised concerns in its Direct and Rebuttal Testimony as to the following issues:

a) the scope of its obligation to provide Standard Offer Service in light of the Commission's Electric Competition Rules and the Arizona Electric Competition Act;

b) its ability to build or buy new generation resources that would be subject to traditional cost of service ratemaking in the aftermath of the Track A and Track B Decisions; and,

c) the Company's authority to join and participate in a FERC-regulated regional transmission organization ("RTO") or similar entity.

(Wheeler Rebuttal Test., Ex. APS-2R at 40-41). The Proposed Settlement resolves each of these issues. But at the same time, the Proposed Settlement language recognizes that APS resource planning must take the existence of retail access into consideration in determining the proper portfolio of resources needed to meet a retail market demand that under a retail access program is free to leave at any time to a competitor of APS. The Proposed Settlement further acknowledges the right of parties to seek prospective changes to the Company's obligation to serve, either at the Commission or through the legislative process. Finally, the ability of APS to build and rate base new generation is made expressly subject to the other provisions of the Proposed Settlement, specifically Section IX.

Some parties to this proceeding sought a variety of changes to the Retail Access programs and Competition Rules in their direct testimony. The Settlement Parties agreed that the appropriate forum for discussion of changes to the Competition Rules would be the Electric Competition Advisory Group ("ECAG") or a similar process so that issues can be resolved on a statewide basis (Summary of Chamberlin Test. at 3). The direct testimony of CNE/SE Witness Mark Fulmer (Ex. CNE/SEL-1 at 19) raised the concern that the language contained in the Competition Rules limiting the resale of Revenue Cycle Services by Affected Utilities potentially impairs the ability of Direct Access customers to choose the provider of Revenue Cycle Services that would provide the best service at the best price. This concern is one that is to be explicitly addressed by the ECAG process or similar proceeding as a result of the Proposed Settlement. Whether termination of retail access would be an appropriate issue for consideration in the ECAG process is not addressed in the Settlement.

While Paragraph 81 of the Proposed Settlement confirmed that APS currently has the right and obligation to plan for and serve all customers in its service territory, Paragraph 85 indicates that the Proposed Settlement's acknowledgement of such an obligation does not in and of itself create an exclusive right to serve. The *Hohokam* decision (*Hohokam Irr. And Drainage Dist. v. APS*, 204 Ariz. 394, 64 P.3d 836 (Ariz. 2003)) recognized the right under existing Arizona law of an irrigation district to serve within a utility's certificated service area; existing Arizona law also provides for competitive access in a utility's certificated service area for electric service providers to provide designated competitive electric services. The Proposed Settlement does not alter either of these examples of non-exclusivity and also confirms that Section X of the Proposed Settlement is not intended to prevent the Commission or any other governmental entity from amending the laws and regulations relative to public service corporations.

IX. DEMAND SIDE MANAGEMENT AND RENEWABLES.

A. Introduction.

The Proposed Settlement provides the Commission with an unprecedented opportunity to significantly advance the utilization of demand side management ("DSM") and renewable energy resources within APS' service territory. The Proposed Settlement dramatically increases spending by APS on energy efficiency DSM programs within all customer classes and establishes a special solicitation for renewable energy in 2005 and on a continuing basis thereafter. At the same time, the Proposed Settlement does not alter the existing Environmental Portfolio Standard. It does, however, require that a rulemaking proceeding be initiated allowing the Commission to consider future additional renewable energy requirements for all jurisdictional Arizona utilities, including APS, in the future.

The DSM and renewable energy provisions of the Proposed Settlement establish a substantial foundation for less volatile and potentially less expensive energy resources for APS' customers for years to come. They also allow for these cleaner resources to become formally integrated into future APS resource procurements. It is doubtful that the benefits associated with the DSM and renewable energy provisions of the Proposed Settlement could have been achieved through the litigation process. An additional benefit to settlement of these issues is the cooperation among the parties, and particularly APS, in implementing programs they had a part in developing. This cooperation will help to ensure the success of the DSM programs and renewable energy procurement process.

B. The DSM Provisions are in the Public Interest.

Demand side management issues are addressed in the Proposed Settlement in three areas: (1) DSM funding, programs, plans, and related provisions (Section VII of the Proposed Settlement); (2) a study of rate design modifications to encourage energy efficiency and peak demand reductions (Settlement Agreement at ¶ 57); and (3) DSM as an allowed and invited resource in competitive solicitations. Id. at ¶¶ 58 and 78(d).

1. DSM Funding, Programs, Plans, and Related Provisions (Settlement Agreement, Section VII).

Under the Proposed Settlement, annual funding for eligible DSM-related items is increased to at least $16 million. (Settlement Agreement at ¶ 40). The $16 million is comprised of an annual $10 million base rate DSM allowance plus on average at least another $6 million annually through a DSM adjustment mechanism. Id. at ¶¶ 40, 43, and 44. Funding DSM through a combination of base rates and a lagged adjustor mechanism is a very creative approach to achieve the desired end of increasing DSM expenditures to benefit consumers. (Ahearn, Tr. at 848).

"Eligible DSM-related items" include and are limited to energy efficiency DSM programs, a performance incentive for APS, and low income bill assistance (Settlement Agreement at ¶¶ 40, 42, and 45). To ensure effective and appropriate Commission oversight, the Proposed Settlement requires that all DSM programs be reviewed and pre-approved by the Commission. Id. at ¶¶ 41 and 48. All DSM programs must be pre-approved by the Commission before APS may include their costs in any determination of total DSM costs incurred. Id. at ¶ 41.

APS may gradually phase-in its DSM spending. Id. at ¶ 44. However, to ensure significant and substantial efforts in the early period of DSM implementation and expansion, APS is obligated to spend at least $48 million on approved eligible DSM-related items in the initial three-year period of calendar years 2005 through 2007 (Settlement Agreement at ¶ 44; Schlegel, Tr. at 935). Also, APS is obligated to spend at least $13 million on approved eligible DSM-related items during 2005, subject to the Commission's timely approval of sufficient programs, with the $13 million spending obligation pro-rated for 2005 based on the timing of Commission approval of the

DSM Final Plan (Settlement Agreement at ¶ 44). In no event will the pro-ration reduce APS' 2005 DSM spending obligation below the annual $10 million base rate DSM allowance. Id.

The increase in funding for eligible DSM-related items, to $16 million total annually and to at least $48 million over 2005-2007, is reasonable and justified (Summary of Schlegel Settlement Test. Ex. SWEEP-1 at 1). The increase in DSM funding is a valuable and meaningful step towards encouraging and supporting increased energy efficiency to benefit APS customers. Id. Increasing energy efficiency can provide significant and cost-effective long-term benefits for APS customers (residential consumers and businesses), the electric system, the economy, and the environment (Schlegel Settlement Test., Ex. SWEEP-2 at 2). The DSM funding level of $16 million annually would be equivalent to about $0.65 per month for the average APS residential customer in 2005. Id. at 3.

Under the Proposed Settlement, a DSM adjustment mechanism will be established for any approved DSM expenditures in excess of the annual $10 million base rate DSM allowance (Settlement Agreement at ¶ 43). The DSM adjustor rate, initially set at zero, would be reset each March 1, beginning on March 1, 2006, with recovery of DSM expenditures in a given program year lagged to the post-March 1 period in the subsequent year. Id. The per-kWh charge for the year will be calculated by dividing the account balance by the number of kWh used by customers in the previous calendar year. Id. Although the dollars assigned for recovery under the DSM adjustor to each customer is based on kWh, General Service customers that are demand billed will pay a per kW charge instead of a per kWh charge. Id.

The Proposed Settlement requires low income weatherization funding of at least $1 million annually, as part of the $16 million of annual DSM funding, with the low income funding being part of the $10 million base rate DSM allowance. Id. at 42. This is an increase of at least $500,000 above the current funding level for low income weatherization of $500,000 annually (Schlegel Settlement Test., Ex. SWEEP-2 at 3). It is very important to have a distinct weatherization program targeted to low income customers, with a program design that is appropriate and effective for those customers, to ensure that low income customers benefit from the DSM program funding

(Schlegel, Tr. at 886-87). Up to $250,000 of the $1 million may be applied to low income bill assistance during any calendar year (Settlement Agreement at ¶ 42).

The Proposed Settlement provides additional funding flexibility for DSM. (Settlement Agreement at ¶ 49; Summary of Schlegel Settlement Test., Ex. SWEEP-1 at 2). In particular, APS may request Commission approval for additional DSM program funding, through the DSM adjustment mechanism, that exceeds the $16 million per year amount described above. Such additional funding could cover demand response and additional energy efficiency programs. Id.

The Proposed Settlement provides safeguards and processes to ensure that the level of DSM expenditures will be reasonable and that the programs will be cost-effective. These safeguards and processes include Commission review and pre-approval of DSM programs and plans, return of unspent amounts in base rates to customers, APS filing of periodic reports on its DSM programs, stakeholder input and review through the collaborative DSM working group, and measurement and evaluation to document DSM program performance (Keene, Tr. at 852; Settlement Agreement at ¶¶ 41, 48, 51, 52, 54, and Appendix B; Schlegel, Tr. at 951-53).

APS will have the opportunity to earn a performance incentive based on a share of net economic benefits (benefits minus costs) achieved by the energy efficiency programs, capped at 10% of total DSM spending, inclusive of the performance incentive (Settlement Agreement at ¶ 45). The performance incentive is a positive mechanism to encourage APS to be effective and cost-efficient in administration, program design, and implementation (Schlegel Settlement Test., Ex. SWEEP-2 at 3-4). The specific performance incentive will be proposed in the DSM Final Plan to be submitted to the Commission for its review and approval subsequent to approval of the Settlement Agreement (Settlement Agreement at ¶¶ 45 and 48).

The Proposed Settlement does not provide for recovery of net lost revenues. Id. at ¶ 46.

APS is required to develop a DSM Final Plan for Commission review and approval before DSM programs can be implemented. Id. at ¶¶ 41 and 48. The inclusion of the Preliminary Plan in the Proposed Settlement (Appendix B) was intended to give Commissioners initial, preliminary information that they could review and react to early in the process of expanding DSM efforts. (Ahearn, Tr. at 943-44; Schlegel, Tr. at 945-46). The Preliminary Energy Efficiency DSM Plan

(Appendix B of the Proposed Settlement) summarizes a portfolio of effective and cost-effective energy efficiency programs to achieve meaningful energy savings and peak demand reductions (Settlement Agreement at ¶ 47; Summary of Schlegel Settlement Test., Ex. SWEEP-1 at 2). Implementing the portfolio of programs in the Preliminary Plan will ensure that all customer groups will have an opportunity to participate in and benefit directly from the energy efficiency programs (Summary of Schlegel Settlement Test., Ex. SWEEP-1 at 2; Schlegel, Tr. at 882-88). The allocation of the DSM program funding in the Preliminary Plan to residential versus non-residential customers was based on the proportions of energy sales in the 2002 Test Year, and therefore it is a reasonably fair and equitable preliminary proposed allocation (Schlegel, Tr. at 880-81).

A collaborative working group will be implemented to solicit and facilitate stakeholder input, advise APS on program implementation, develop future DSM programs, and review DSM program performance (Settlement Agreement at ¶ 54). The collaborative working group will provide a valuable forum for stakeholder input and review, thereby increasing stakeholder support for the cost-effective programs ultimately proposed to the Commission (Summary of Schlegel Settlement Test., Ex. SWEEP-1 at 2). The collaborative working group is an additional mechanism to ensure effective and cost-effective DSM programs to benefit APS customers. Id.

Energy efficiency for schools is identified as a priority in the Preliminary DSM Plan (Settlement Agreement, Appendix B; Schlegel, Tr. at 992-93). Native American entities and customers served by APS would be eligible to participate in the DSM programs proposed in the Settlement Agreement (Robinson, Tr. at 1055).

In summary, the increase in energy efficiency DSM efforts, funding, and programs will enhance the opportunity for significant benefits for APS customers, the electric system, the economy, and the environment (Summary of Schlegel Settlement Test., Ex. SWEEP-1 at 1). The Proposed Settlement requires APS to implement considerably more DSM than is being done today, resulting in customer savings, utility cost reductions, and reduced impact on the environment (Keene, Tr. at 851-52). The DSM programs must be approved by the Commission before they can be implemented (Settlement Agreement at ¶ 41). Implementing the energy efficiency and DSM provisions set forth in the Proposed Settlement should result in meaningful positive net benefits (benefits that exceed costs) for APS customers, thereby demonstrating that the provisions are in the public interest. (Summary of Schlegel Settlement Test., Ex. SWEEP-1 at 1).

2. Rate Designs to Encourage Energy Efficiency and Peak Demand Reductions.

Rate designs that encourage energy efficiency, discourage wasteful and uneconomic use of energy, and reduce peak demand are integral parts of an overall DSM strategy (Settlement Agreement at ¶ 57). The Proposed Settlement requires APS to conduct a study analyzing rate design modifications that could achieve these objectives, including, among others, consideration of mandatory TOU rates and/or expanded use of inclining block rates. Id. APS will submit the study results and rate design analysis to the Commission as part of its next general rate application or within 15 months of approval of the Settlement Agreement, whichever occurs first. Id. If the study and analysis indicate that the rate design modifications are reasonable, cost-effective, and practical, APS is required to develop and propose to the Commission any appropriate rate design modifications. Id.

3. DSM in Competitive Solicitations.

Under the Proposed Settlement, APS is to allow and invite DSM resources to participate in its RFP or other competitive solicitations, and is required to evaluate the DSM resources in a consistent and comparable manner. Id. at ¶ 78(d). The DSM activities described above and set forth in Section VII of the Proposed Settlement are in addition to any DSM acquired as part of the competitive procurement processes described in Section IX. Id. at ¶ 58. The Commission Staff will schedule resource planning workshops to develop a flexible, timely, and fair competitive procurement process, and to consider whether and to what extent the competitive procurement should include an appropriate consideration of a diverse portfolio of resources including DSM. Id. at ¶ 79. Expanding APS' resource options to include competitively-procured DSM is in the public interest because doing so may reveal resources with lower costs or reduced environmental impacts relative to conventional resources that would otherwise be considered by APS.

C. The Renewable Energy Provisions are in the Public Interest.

The Proposed Settlement addresses three aspects of renewable energy resources: a) acquisition of renewable energy through a special solicitation as a hedge against moderate or high natural gas prices; b) the Environmental Portfolio Standard ("EPS"); and c) inclusion of renewable energy in future competitive procurements.

1. Special Renewable Energy Solicitation.

APS has a large exposure to moderate or high natural gas prices and such price levels have occurred in recent years (Berry Direct Test., Ex. WRA-4 at 2; Berry Settlement Test., Ex. WRA-2 at 2 and Ex. DB-5). Each dollar increase in the price of natural gas translates into additional costs for APS and its ratepayers of $55 million in 2004 and $65 million in 2005 (Ewen Rebuttal Test., Ex. APS-11R at 5). Low cost, stably priced renewable energy can serve as a hedge against moderate and high natural gas prices (Berry Direct Test., Ex. WRA-4 at 10-12 and Ex. DB-4), thereby lowering costs (and assuming a PSA or similar mechanism, rates) in years when gas prices are moderate or high. Thus, acquisition of significant quantities of energy from reasonably and stably-priced renewable energy resources is in the public interest.

The Proposed Settlement (¶¶ 69–72) requires APS to solicit, through a special RFP, at least 100 MW of renewable resources with delivery of energy starting in 2006. Thereafter, APS must attempt to obtain at least 10 percent of its growth in capacity needs from renewable resources. This amounts to approximately 30 to 35 MW of additional renewable resources per year on average. (Berry Settlement Test., Ex. WRA-2 at 3). Further, the Proposed Settlement (¶ 68) requires Staff to initiate a rulemaking proceeding to consider modification to the Environmental Portfolio Standard, thereby enabling the Commission to consider additional renewable energy requirements that could expand the hedging of moderate or high natural gas prices with renewable energy.

The Proposed Settlement requires APS to obtain renewable energy at fixed or stable prices (¶ 69(f)) and caps the cost of the renewable resources to be acquired in the special solicitation at 125 percent of the reasonably estimated market price of conventional resources (¶ 69(g)). The 25 percent premium cap protects ratepayers (Berry Settlement Test., Ex. WRA-2 at 6) while incorporating environmental benefits of renewable resources and allowing for errors in forecasting the benchmark price of conventional resources. Id. at 6-7. Wind, biomass, and geothermal resources may beat the price cap. Id. If APS is unsuccessful in meeting the 100 MW goal, APS will file a notice with the Commission describing the shortfall in renewable resources, explaining the circumstances leading to the shortfall and recommending actions to the Commission. (Proposed Settlement at ¶ 71).

All costs of the resources obtained through the special solicitation will be recovered through the Power Supply Adjustor except for the cost premium (i.e., costs above the market price) of EPS-eligible resources for which there is adequate EPS funding. Id. at ¶¶ 69(h), 69(i), 69(j). These latter costs would be recovered through the EPS cost recovery mechanism as described in the section below.[5]

Environmental improvements associated with power supply are also in the public interest. The acquisition of significant amounts of renewable energy can result in reduced emissions of nitrogen oxides, sulfur dioxide, and carbon dioxide (Berry Direct Test., Ex. WRA-4 at 7 and Ex. DB-4). Thus, if renewable energy substitutes for fossil fuel generation, the environmental impacts of power production will decrease.

The Proposed Settlement allows APS to engage in comparison shopping to obtain the best deal on renewable energy, whether the best resources are located in Arizona or in another state (¶ 691). For example, APS may find the lowest cost geothermal resources in California and the lowest cost wind resources in New Mexico (Berry Settlement Test., Ex. WRA-2 at 5). Enabling APS to shop around among resources in several states, instead of looking only at Arizona resources, is in the public interest because shopping around may save significant money for ratepayers. Id. The present value of such savings may exceed $100 million (Western Resource Advocates December 10, 2004 Response to Questions from Chairman Spitzer, at 5 and Table 2).[6] Further, restricting APS to acquire

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[5] If EPS funding is insufficient to recover the premium associated with EPS-eligible resources, that cost premium would be recovered through the Power Supply Adjustor. The net proceeds from the sale of any environmental credits or tags attributable to the renewable resources are to be credited to the EPS account. Id. at ¶ 96(k).

[6] Saving millions of dollars as a result of out-of-state purchases of renewable energy allows ratepayers to purchase other goods and services with those savings. The Arizona employment impact of making additional purchases of goods and services from savings may exceed any Arizona employment impact of requiring APS to obtain its renewable energy resources only from within the state.

only Arizona renewable resources may result in no resources meeting the cost cap (Settlement Agreement at ¶ 69(g)).

The Parties to the Proposed Settlement understood that the Commission's preference, if it could be lawfully and economically accomplished, would be for APS to acquire all of the renewable resources required by ¶ 69 of the Agreement from sources within Arizona. The Commission has expressed a similar preference for the energy requirements associated with the Environmental Portfolio Standard. A.A.C. R14-2-1618(C)(2), (I), (L).

While recognizing the desirability of an in-state preference, the Parties agreed that there were substantial and serious legal issues associated with an explicit preference for in-state resources in addition to the economic issues described above. Although no litigation has been filed challenging the preference under the EPS, the Parties are very concerned that the size of the renewable resources RFP could make it worthwhile for an out-of-state provider or for APS customers to challenge any similar limitation imposed by the Proposed Settlement.

Governmental efforts to limit competition or benefits on a local or in-state basis have been uniformly rejected by federal courts as violating the Commerce Clause in the U.S. Constitution. U.S. Const., art. I, § 8, Cl. 1, 3. ("Congress shall have power . . . to regulate commerce . . . among the several states."). Although the Commerce Clause is phrased as an affirmative grant of regulatory power to Congress, the U.S. Supreme Court has long interpreted the clause to have a "negative aspect," referred to as the dormant commerce clause, "that denies the states the power unjustifiably to discriminate against or burden the interstate flow of articles of commerce." *Or. Waste Sys., Inc. v. Dep't of Envtl. Quality*, 511 U.S. 93, 98 (1994). A statute that explicitly discriminates against interstate commerce on its face is "virtually per se illegal . . ." *Pike v. Bruce Church, Inc.*, 397 U.S. 137, 145 (1970). Such a statute is subject to strict scrutiny analysis requiring the state to demonstrate "that it has no other means to advance a legitimate local interest." *C & A Carbone v. Town of Clarkstown,* 511 U.S. 383, 392 (1994). "Preservation of local industry by protecting it from the rigors of interstate competition is the hallmark of the economic protectionism that the Commerce Clause prohibits." *West Lynn Creamery v. Healy*, 512 U.S. 186, 205 (1994).

A requirement that APS obtain the renewable resources called for by the Proposed Settlement from sources within Arizona may constitute discrimination against interstate commerce "by prohibiting patronage of out-of-state competitors" to "favor local enterprise . . ." *Carbone*, *supra*, 511 U.S. at 394. Without a compelling showing that that an in-state preference is the only way to accomplish the Commission's otherwise legitimate objectives, an in-state requirement would raise questions under the Commerce Clause.

As a result, the Parties to the Proposed Settlement developed language that provides for the utilization of in-state renewable resources "where feasible" but allows APS to acquire qualifying out-of-state resources if it does not receive sufficient in-state qualified bids. (Settlement Agreement at ¶ 69(l)). The Parties believed that this language achieves an appropriate balance between encouraging the use of in-state resources "where feasible" and permitting APS to acquire out-of-state resources particularly when it would be in the best interest of its ratepayers.

The Parties believe that the language in the Proposed Settlement is important to preserve its legality. The renewable resource RFP is one of the major benefits of the Proposed Settlement. Any modification to the existing language in ¶ 69(l) would place the renewable resource RFP at significant risk and could provoke litigation invalidating the entire provision. At a minimum, litigation would introduce uncertainty for APS and resource developers until the issue was resolved, possibly halting the acquisition of renewable energy.

2. Environmental Portfolio Standard.

The Proposed Settlement does not itself alter the existing Environmental Portfolio Standard or the current level of funding (Proposed Settlement at ¶¶ 61– 67). However, it changes the existing EPS surcharge for APS into an adjustment mechanism to give the Commission flexibility to change funding levels and rates in the future (¶ 63) while retaining the existing structure of the surcharge rate design. Making such a change in the APS rate proceeding is certainly appropriate. *See* Op. Atty. Gen. 71-15. The Proposed Settlement also enables APS to apply to the Commission for additional funding of the EPS (¶ 64) and requires Staff to initiate a rulemaking proceeding to modify the EPS (¶ 68). Further, the Agreement does not alter the EPS requirements applicable to APS (¶ 72) but does allow resources acquired under the special solicitation to be counted toward meeting the company's EPS requirements if those resources are EPS eligible (¶ 69(m)). These provisions are in the public interest because they retain the Commission's existing EPS policy, allow for the Commission to increase funding of the EPS in the future, and allow future Commission modification of the EPS (Seitz Settlement Test. at 3).

3. Competitive Procurement of Power.

Under the Proposed Settlement, APS is to allow and encourage all renewable resources to participate in its efforts to procure power competitively (Proposed Settlement at ¶¶ 73, 78(d)). Expanding APS' resource frontier is in the public interest because doing so may reveal resources with lower costs or reduced environmental impacts relative to conventional resources that would otherwise be considered by APS.

X. ADJUSTORS AND SURCHARGES

A. Power Supply Adjustment Mechanism.

1. Introduction

Section IV of the Proposed Settlement sets out the key provisions for a Power Supply Adjustor ("PSA") to be implemented by APS. The Parties to the Proposed Settlement recognized the value to both the Company and its customers of implementing the adjustment mechanism incorporated in the Proposed Settlement. (*See, e.g.,* Keene and Gray Settlement Report, Ex. S-20 at 4; Robinson Settlement Direct Test., Ex. APS-2SD at 9-10; Kurtz, Tr. at 61). As mentioned above, the approval of the PSA also was identified by the ratings agencies as critical to maintaining the Company's current investment grade credit ratings.[7]

There is no dispute that APS is increasingly dependent on natural gas, both to run its own generating facilities and through its rapidly increasing dependence on purchased power, which is predominantly gas-fired. This is particularly true with the rate basing of the PWEC Assets. (Diaz

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[7] Although the ratings agencies viewed the Proposed Settlement as a welcome resolution of contentious issues, they expressed continuing concerns about the Company's future financial condition due to the modest rate increase provided in the Proposed Settlement. Thus, Standard & Poor's, Moody's and Fitch all have maintained their Negative outlooks on the Company. *See* Fetter Settlement Direct Test., Ex. APS-4SD at 13-18; Robinson Settlement Direct Test., Ex. APS-2SD at 4-5).

Cortez Settlement Direct Test., Ex. RUCO-10 at 5-6; Ahearn, Tr. at 393). Nor is there any dispute that prices for both natural gas and purchased power have become increasingly volatile. (Robinson Rebuttal Test., Ex. APS-4R at 11-12; Diaz Cortez, Tr. at 1158-59). These and other factors led the settling parties to support the implementation of a PSA, which was a critical element of the Proposed Settlement for APS due to the financial impact on the Company if such a mechanism was not included.

By definition, fuel and purchased power costs reasonably incurred by the Company to serve customers are costs that the Company is entitled to recover. Under the Proposed Settlement, the Commission retains its existing authority to review the prudence of the Company's fuel and purchased power acquisitions, and any costs found by the Commission not to be prudently incurred are subject to refund. (Proposed Settlement at ¶¶ 19(i) and 19(k)). The Company will make no profit on its fuel and purchased power acquisitions but merely will flow through to customers the prudently incurred costs. According to APS, if the PSA were to be rejected by the Commission, the financial impact on the Company would be dramatic. Staff's response to Commissioner Mayes' "homework" request demonstrates a potential financial impact. Using Staff's "most likely" scenario of a price of $5.78 per MMBtu for natural gas, a rejection of the PSA by the Commission would result in the Company not being able to recover prudently incurred costs of more than $54,000,000. (Staff Response to Request for Analysis, Ex. S-21 at 10, 13; Gray, Tr. at 1181).

The PSA set forth in the Proposed Settlement is similar in many respects to adjustment mechanisms approved by the Commission in other proceedings and to the PSA approved by the Commission in APS' PSA proceeding. *See* Decision No. 66567 (November 18, 2003). In response to concerns stated by Staff and RUCO regarding the PSA that APS initially sought in this case, APS proposed certain modifications in its Rebuttal Testimony that were adopted, some with further modification, for the PSA in the Proposed Settlement. The final PSA incorporated into the Proposed Settlement appropriately balances the interests of customers and the Company. As Staff noted:

> The PSA contained in the proposed settlement agreement contains a variety of provisions which addresses both the interests of ratepayers and APS in a reasonable fashion. While no adjustor can fully protect ratepayers from the underlying volatility of energy markets, the proposed PSA helps shield ratepayers from price volatility through the provision of regular adjustments

> of the adjustor rate, the inclusion of a bandwidth limiting the amount of automatic adjustment in the adjustor rate, and the provision of the opportunity for cost recovery of the costs of hedging fuel and purchased power costs. Further, APS is motivated to minimize the cost of fuel and purchased power through the 90/10 sharing mechanism.
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> *   *   *
>
> In summary, Staff believes the adjustor provisions contained in the proposed settlement agreement are in the public interest, as they reasonably balance the interests of ratepayers and APS and provide a variety of incentives to the Company to manage the PSA in a manner which is beneficial to its ratepayers while also providing the opportunity to address any problems which may arise in the future operations of the PSA.

(Gray and Keene Settlement Staff Report, Ex. S-20 at 4; see also Gray, Tr. at 1160; Diaz Cortez, Tr. at 1158, 1177-79).

2. Key Elements of the PSA.

As mentioned above, the PSA included in the Proposed Settlement incorporates the elements approved by the Commission in Decision No. 66567, with some modifications to address concerns expressed by both the Commission and settling parties. As APS witness Don Robinson testified, the PSA set forth in the Proposed Settlement includes the following key elements:

- The PSA includes both fuel and purchase power.
- The adjustor rate will initially be set at zero and not adjusted for the first time until April 1, 2006; the maximum adjustment in any one year will be plus or minus $0.004 per kilowatt hour ("kWh") with any additional amounts carried over.
- APS and its customers will share in the costs or savings on a 90% customers/10% APS basis.
- Subject to certain limited exceptions, customers will receive the benefits of all off-system sales.
- The Commission and its Staff retain the ability to review the prudence of all fuel and power purchases at any time and any costs flowed through the PSA will be subject to refund if the Commission finds that such costs were not prudently incurred.

- APS will provide detailed and certified monthly reports to the Commission and RUCO encompassing an extensive amount of information relating not only to the PSA calculations, but also to the APS generating units and to its power and fuel purchases. Certain information may be provided confidentially.
- The minimum life of the PSA will be five years from the date that rates under the proceeding go into effect. Within four years, APS shall file a report that addresses the various aspects of the PSA and provides recommendations regarding the continuation of the PSA. After the five-year period, the Commission may abolish the PSA without a rate case but will incorporate provisions to address any under-recovery or over-recovery existing at the time of the termination.
- The base cost of fuel and purchased power reflected in APS' base rates will be $0.020743 per kWh.

(Robinson Settlement Direct Test., Ex. APS-2SD at 9).

The Parties believe that the proposed PSA is in the public interest. As reflected in the above summary of the elements of the PSA, the PSA set forth in the Proposed Settlement includes a number of provisions designed to address both the interests of customers and the Company in a reasonable manner. The PSA helps protect customers from the volatility of fuel and purchased power prices by limiting the annual automatic adjustment in the PSA rate through the bandwidth limit, encouraging the Company to continue its hedging program, and permitting the Commission to periodically adjust the PSA to avoid the development of a large bank balance that ultimately would have to be paid by customers. (Gray, Tr. at 1160-61; Diaz Cortez, Tr. at 1178-79). The ability of the Commission to authorize the refund or collection of the balancing account over twelve months once the account reaches $50 million provides the Commission with flexibility to mitigate impacts on customers while providing customers with appropriate price signals. (Johnson, Tr. at 383-84; Wheeler, Tr. at 388, 391; Diaz Cortez, Tr. at 1184; Robinson, Tr. at 1184-85).

The PSA also includes a further incentive for the Company to minimize the cost of fuel and purchase power through the 90/10 sharing mechanism, which provides customers with the benefits of off-system sales margin.[8] (Proposed Settlement at ¶ 19(c)). Although APS believes that it should be able to recover all of its prudent costs of providing service to its customers, including fuel and purchase power costs, it proposed in its Rebuttal Testimony a $20 million cap on its portion of the sharing mechanism. (Robinson Rebuttal Test., Ex. APS-4R at 15-16). In the context of the global settlement reached with the other Parties, the Company agreed to eliminate that cap, thereby exposing the Company to an increased level of risk and providing an additional incentive for the Company to mitigate fuel and purchased power costs. (Ahearn, Tr. at 394). In addition to the sharing mechanism, the Commission continues to have the ability to review the Company's fuel and purchased power program for prudency, which provides an incentive for the Company to effectively implement its hedging program to help smooth out the volatility. (Wheeler, Tr. at 395-96).

B. Competition Rules Compliance Charge.

The Competition Rules Compliance Charge ("CRCC"), set forth in Section XI of the Proposed Settlement, is a surcharge designed to allow APS to recover costs it incurred related to the transition to retail competition as ordered by the Commission, including costs associated with the implementation of Direct Access and costs associated with the divestiture of the APS generating assets. (Gray and Keene Settlement Report, Ex. S-20 at 3; Robinson Direct Test., Ex. APS-3 at 49). The CRCC sought by APS in its original rate case filing was consistent with the 1999 Settlement and Commission Decision No. 66567. No party opposed the Company's request for implementation of a CRCC or questioned the basis for the Company's request to recover such costs. Staff only questioned certain costs included in the Company's calculation of the total amount to be recovered.

The Proposed Settlement adopts the CRCC requested by the Company with certain adjustments proposed by Staff to the amount to be recovered. Specifically, the Proposed Settlement authorizes APS to recover $47.7 million of transition costs plus interest though a surcharge of

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[8] During the course of the hearing, APS, Staff, RUCO and AECC agreed on the calculation of off-system sales margin to be included in the sharing mechanism. *See* Ex. APS-21 (Agreement on Power Supply Adjustor Treatment of System Book Off-System Sales Revenue).

$0.000338/kWh over five years. (Proposed Settlement at ¶¶ 86-89). As indicated by Mr. Robinson during the hearing, the Company anticipates that the total amount to be collected under the CRCC over that period, including interest, is approximately $49.3 million. (Robinson, Tr. at 823). Once the amount is recovered, the CRCC will terminate. If any amount remains uncollected at the end of the five years, the Company will file an application with the Commission to adjust the CRCC to recover the remaining balance. The Company also will file a plan of administration for the CRCC as part of its tariff compliance filing for this docket. (Proposed Settlement at ¶¶ 87, 89).

C. Returning Customer Direct Access Charge.

The Returning Customer Direct Access Charge ("RCDAC") adopted by the Proposed Settlement is the same RCDAC approved by the Commission in Decision No. 66567, with minor clarifications sought by the Energy Service Providers that intervened in the rate case. Id. at ¶¶ 94-96. The RCDAC authorizes APS to recover costs it might incur when certain customers or groups of customers return to Standard Offer Service from Direct Access Service. APS proposed the RCDAC to ensure that its current Standard Offer customers would not experience increased costs when those customers who elected to go to Direct Access decide to return to Standard Offer Service. (Rumolo Settlement Direct Test., Ex. APS-3SD at 14). Although the most likely source of increased costs would be power supply, the actual amount assessed such returning customers will be fact dependant.

Three key elements of the RCDAC are set out in the Proposed Settlement: (i) the RCDAC applies only to individual customers or aggregated groups with a load of 3 MW or greater; (ii) the RCDAC does not apply to any customer or aggregated group which provides APS with a one-year notice of intent to return to Standard Offer Service; and (iii) the RCDAC rate schedule will include a breakdown of the individual components of the potential charge, definitions of the components, and a general framework that describes the way in which the RCDAC will be calculated. In addition, regardless of the amount of the RCDAC, it will be recovered over no more than a twelve-month period. (Proposed Settlement at ¶¶ 94-95; *see also* Rumolo Settlement Direct Test., Ex. APS-3SD at 14-15; Gray and Keene Settlement Report, Ex. S-20 at 3). Finally, the Company will file a plan of administration for the RCDAC as part of its tariff compliance filing. (Proposed Settlement at ¶ 96).

The RCDAC is designed to both ensure that all customers have the ability to move to Direct Access with the assurance that they may return to Standard Offer Service if they choose to do so, while protecting both the Company and other Standard Offer Service customers from unanticipated costs of such returning customers. Because the RCDAC balances those interests, it is in the public interest.

D. Transmission Cost Adjustor.

The Transmission Cost Adjustor ("TCA") included in the Proposed Settlement at Section XVI is a critical part of the unbundling of rates ordered by the Commission and was supported by both Staff and AECC from the beginning of APS' rate case. (Smith Redacted Direct Test., Ex. S-7 at 39; Higgins Direct Test., Ex. AECC-1 at 32).[9] The TCA allows APS to adjust the transmission cost element of unbundled retail rates to reflect changes in transmission rates authorized by the Federal Energy Regulatory Commission ("FERC"). If APS files an application with FERC to change transmission rates, the Company will file a notice with the Commission of its application, which will provide the Commission an opportunity to participate in any FERC proceeding. (Proposed Settlement at ¶ 105). Moreover, the TCA will not take effect until the transmission component of retail rates exceeds the test year base of $0.00476/kWh by five percent and only after the Commission approves a change in the rate. Id. at ¶106; *also* Keene, Tr. at 1281. These provisions ensure that Direct Access customers will pay the same for transmission as Standard Offer customers. (Proposed Settlement at ¶ 104; Rumolo Settlement Direct Test., Ex. APS-3SD at 13-14; Keene, Tr. at 1281). Thus, the TCA helps further retail competition and is in the public interest.

E. DSM and EPS Adjustors.

The Proposed Settlement provides for Demand Side Management ("DSM") and Environmental Portfolio Standard ("EPS") adjustment mechanisms to be implemented by APS. (Proposed Settlement at ¶¶ 43, 63).[10] The Parties ultimately decided to implement adjustors because

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[9] Although RUCO initially opposed the implementation of a TCA out of a concern that a TCA could be interpreted as the ceding of jurisdiction over retail rates by the Commission to FERC, that concern is alleviated in part by the requirement that the Commission approve any TCA rate before it is implemented. (*See* Proposed Settlement at ¶ 106).

[10] This section discusses only the EPS and DSM adjustment mechanisms. Other provisions relating to DSM and EPS are discussed at § IX of this brief.

they provide the Commission with the flexibility to adjust DSM and EPS spending to reflect Commission-approved programs and the Commission's funding requirements. In combination with the other elements of the Proposed Settlement, the DSM and EPS adjustors are in the public interest.

The DSM adjustment mechanism will allow APS to recover Commission-approved DSM expenditures in excess of the $10 million base rate DSM allowance. The adjustor rate initially is set at zero and will be reset on March 1, 2006 and each March 1 thereafter. Pursuant to the Proposed Settlement, APS will file a request with the Commission each year prior to March 1, with supporting documentation, to adjust the DSM adjustor rate to reflect actual expenditures on Commission-approved programs during the prior year. The Proposed Settlement specifies both how the rate is to be calculated and how it is to be assessed. The DSM adjustor will be applied to both Standard Offer and Direct Access customers. (Proposed Settlement at ¶ 43; *see also* Keene Settlement Report, Ex. S-17 at 2-3). The use of such an adjustment mechanism provides the Commission with flexibility to change funding levels to match Commission-approved programs.

The Proposed Settlement also converts the existing EPS surcharge to an adjustment mechanism without changing the current funding level. Under the Proposed Settlement, APS will continue to recover $6 million annually in base rates, but the existing EPS surcharge will be converted to an adjustment mechanism to allow for Commission-approved changes to APS' EPS funding levels. (Proposed Settlement at ¶ 63). Paragraph 63 provides the Commission with flexibility to increase funding if it elects to amend existing Rule 1618 or it approves an application by APS to increase EPS funding. Id. at ¶¶ 63-64. APS could not apply to the Commission to increase its EPS funding, however, until one year after the termination of the pending EPS rulemaking docket. Id. at ¶ 64. The EPS adjustor would be recovered from both Standard Offer and Direct Access customers and the amounts recovered from Direct Access customers will be made available by APS to electric service providers for funding their EPS obligations. Id. at ¶ 65.

The EPS adjustor and DSM adjustor would be combined for billing purposes into an "Environmental Benefits Surcharge" for residential customers and may be combined for other customers. (Proposed Settlement at ¶¶ 50, 66; *see generally,* Keene Settlement Report, Ex. S-17 at 2-4; Schlegel, Tr. at 872-73; Keene, Tr. at 873).

XI. BARK BEETLE REMEDIATION.

The Proposed Settlement, in Section XVIII, authorizes APS to defer without a return "the reasonable and prudent direct costs of bark beetle remediation that exceed test year levels of tree and brush control." The Commission will determine the reasonableness, prudence and appropriate allocation between distribution and transmission of such costs, as well as an appropriate amortization period, in the Company's next rate case. (Proposed Settlement at ¶¶ 110-111).

There was little discussion of this section of the Proposed Settlement in either pre-filed settlement testimony or testimony during the hearing. There also was little debate about the extraordinary circumstances that gave rise to APS' request for recovery of such costs. Instead, the debate related only to the method of recovery.

It is undisputed that the State of Arizona is in the midst of an extended drought that has weakened the Ponderosa pine forest trees to the extent that they became susceptible to infestation by bark beetles. The Company estimates that nearly one million dead or dying trees caused by this infestation are within falling distance of its power lines and will need to be removed over the next 3 to 5 years to both protect the transmission and distribution system and avoid the possibility of causing devastating forest fires. Based on historical data for tree removal, APS estimates the average cost at $45 per tree or approximately $33,750,000 for the project. (Robinson Rebuttal Test., Ex. APS-4R at 24-25; Robinson Settlement Direct Test., Ex. APS-2SD at 19-20).

Unfortunately, it is not clear how much, if any, federal funds will be made available to the State or Company for such remediation efforts despite efforts by the Commissioners, Governor Napolitano, and others to secure such funding. Therefore, although recognizing the importance of removing the dead and dying trees to protect APS' power lines, Staff felt that recovery should be through the deferral adopted in the Proposed Settlement because it is a "more precise method of recovery." (Jaress Settlement Test., Ex. S-15 at 17). The Company agreed to the deferral proposed by Staff because it ultimately allows recovery of prudently incurred costs and helps address the Company's financial concerns.

XII. RATE SPREAD / RATE DESIGN.

A. The Rate Spread and Rate Design Incorporated into the Proposed Settlement are Integral Components of the Settlement as a Whole, and as Part of that Comprehensive Package, Produce Results that are Just, Reasonable, and in the Public Interest.

The rate spread and rate design provisions of the Proposed Settlement, including the rates that appear in Appendix J, are an integral part of the comprehensive agreement. These terms, including the spread of rates among classes, the relationship between demand and energy charges, the designation of rate blocks, the differentiation of rates by voltage, and the demarcation of unbundled components, were crafted through intense negotiations among the Parties. Each of these provisions was of material interest in reaching settlement to various signatory Parties representing virtually all of APS' customers. (Higgins, Settlement Direct Test., Ex. AECC/PD/FEA/K-1 at 11, 14-15). As part of the total package, the proposed rate spread and rate designs are just, reasonable and in the public interest. (Andreasen, Tr. at 1311; Diaz Cortez Settlement Direct Test., Ex. RUCO-10 at 6-7; Rumolo Settlement Direct Test., Ex. APS-35D at 19; Higgins Settlement Direct Test., Ex. AECC/PD/FEA/K-1 at 7, 13-14, 16).

B. The Proposed Settlement Spreads the Base Rate Increase in a Manner that Moves Base Rates Closer to Cost-of-Service.

A general principle of ratemaking is that rates should be guided, at least in part, by cost-of-service considerations. (Andreasen Settlement Report, Ex. S-19 at 1). Cost-of-service studies performed by both APS and Staff demonstrate that General Service customers are paying base rates that are above cost-of-service parity. That is, the returns earned from this class are higher than the returns earned from retail customers as a whole. (Higgins Direct Test., Ex. AECC-1 at 32-33; Andreasen Settlement Report, Ex. S-19 at 7). AECC and other general service customers believe that it is important, on the grounds of both equity and efficiency, to take steps to reduce such disparities in rates, while recognizing that it may not be pragmatic to move to cost-of-service based rates all at once, due to the potential rate impact on other classes. (Higgins Settlement Direct Test., Ex. AECC/PD/FEA/K-1 at 7). Moving toward cost promotes both efficient cost recovery and customer equity by reducing subsidizations among customer classes. (Andreasen, Tr. at 1311). The Proposed

Settlement takes a modest step toward addressing existing rate disparities by assigning a slightly smaller increase for the General Service class, 3.57 percent, than for retail customers as a whole. At the same time, the Proposed Settlement limits the impact of the rate increase on customer classes that are below parity, as no rate receives an increase greater than 5 percent. The base rate increase for the Residential class is limited to 3.94 percent.

C. The Proposed Settlement Provides for General Service Rates that are Properly Differentiated by Voltage.

The non-frozen, metered General Service rates proposed in the Proposed Settlement are differentiated by voltage level. That is, customers who are served directly from the transmission system or at primary distribution voltages will receive a lower rate than customers served at secondary voltage. This properly reflects the lower investment required to serve customers at higher voltages. (Rumolo, Settlement Direct Test., Ex. APS-3SD at 11).

Currently, APS' Standard Offer General Service rates do not make a distinction among voltage levels. This absence of voltage-differentiated rates causes a subsidy within the General Service class from higher-voltage customers to lower-voltage customers. The Proposed Settlement corrects this problem in a manner that is consistent with the general approach adopted in the vast majority of utility tariffs across the country. (Higgins Settlement Direct Test., Ex. AECC/PD/FEA/K-1 at 12).

In addition, Paragraph 120 of the Proposed Settlement recognizes that military base customers served directly from an APS substation will not be charged for the cost of APS' primary line and secondary distribution investments, and establishes an appropriate cost-based voltage discount applicable to military base customers with this service configuration. Id. at 12-13. At present, Luke Air Force Base ("Luke") is the only such APS customer, thus recognizing Luke's unique contribution to Arizona and to national security.

D. The Proposed Settlement Provides for Rates that are Unbundled in a Just and Reasonable Manner, Which will Improve the Pricing Information Provided to Customers.

Under the Proposed Settlement, the APS retail tariff will include unbundled rate schedules in accordance with R-14-2-1606(C)(2). The unbundled rates separate competitive electric services such as generation, metering, and meter reading from non-competitive services such as distribution service. (Rumolo Settlement Direct Test., Ex. APS-3SD at 2).

For General Service customers, the unbundled generation component and revenue cycle services are priced at APS' cost-of-service. Consequently, the generation component is set at a rate that is neither below nor above cost, so as not to distort the economics of shopping. (Higgins, Settlement Direct Test., Ex. AECC/PD/FEA/K-1 at 14; Tierney, Tr. at 1314). In separately stating the unbundled cost components on customer bills, it will make the process of evaluating direct access opportunities more transparent for customers who wish to do so, allowing for more informed customer decisions. (Andreasen, Tr. at 1312).

At the same time, APS' rates will also continue to be provided on a bundled basis for Standard Offer service. Customers who are not interested in evaluating direct access service can choose to ignore the unbundled detail in their bills, and simply continue to focus on the bundled rates. (Higgins Settlement Direct Test., Ex. AECC/PD/FEA/K-1 at 14).

E. The Proposed Settlement Modifies Schedule E-32 in a Manner that Simplifies the Design and Makes it More Cost-Based.

The large majority of General Service customers take service under Schedule E-32. As currently designed, Schedule E-32 is quite complex and difficult for customers to understand. The Proposed Settlement significantly simplifies the existing design. For customers of 20 kW or less, the new bundled rate consists of two energy blocks and a basic service charge. For customers over 20 kW in demand, the new bundled rate will consist of a basic service charge, two demand blocks, and two load-factor-based energy charges. (Rumolo Settlement Direct Test., Ex. APS-3SD at 10). The E-32 rate design in the Settlement Agreement is vastly improved relative to the design in the current tariff. (Higgins Settlement Direct Test., Ex. AECC/PD/FEA/K-1 at 15).

The Settlement Agreement's treatment of Schedule E-32 also strikes a proper balance between demand and energy charges. In a system such as APS', in which new distribution infrastructure and new generation resources must be added to meet a growing system peak, it is critical on grounds of both fairness and efficiency to levy a demand charge that sufficiently places cost responsibility on those customers responsible for the costs incurred in meeting the peak needs of the system. The demand charge performs this function. Failure to properly weight demand cost responsibility would cause an improper subsidy among the customers within the E-32 rate schedule, which would result in higher-load-factor customers subsidizing the peak-related costs caused by lower-load-factor customers. The Proposed Settlement achieves a proper balancing of costs through the setting of the demand and energy charges. Id.

F. The Proposed Settlement Increases Customer Options by Making Time-of-Use Rates Available to all General Service Customers.

Currently, time-of-use ("TOU") rates are not available to the large majority of General Service customers that have billing demands under 3000 kW. (Rumolo, Tr. at 1328). Consequently, customers of this size who wish to take advantage of TOU pricing are unable to do so. The Settlement Agreement corrects this by offering Schedule E-32-TOU – a new TOU option that will be open to all General Service customers who would otherwise qualify for Schedule E-32. This TOU option increases the opportunity for customers to alter their usage in response to proper price signals. (Settlement Agreement at ¶ 113). In addition, General Service customers with demands of 3000 kW can continue to select TOU service under Schedule E-35.

G. The Residential Rate Design Proposed by the Agreement will Provide Benefits for Residential Customers.

The Settlement Agreement provides for an overall residential class increase of 3.94%. Agreement, ¶ 113. The general service class schedules provide for increases of 3.5%, and irrigation and lighting class schedules contain increases of 5%. (Diaz Cortez Settlement Direct Test., Ex. RUCO-10 at 6). While the revenue increase is slightly higher for the residential class than for the general service class, the dollar impact of the revenue shift between classes is small, only slightly more than a million dollars. (Diaz Cortez, Tr. at 1307-08). This minor accommodation to some Parties' claims in their direct cases that residential and other rates should produce increased rates of return is a small concession compared to other benefits residential customers receive under the Settlement Agreement. Id. at 1310.

One of the rate design benefits for residential customers is the continuation of two widely used rate schedules that APS had proposed to discontinue. One hundred and twenty thousand customers, about 15% of residential customers, take service under currently-frozen Schedules E-10 (Classic Rate) or EC-1 (Service with Demand Charge). (Stutz Cross-Rebuttal Test., Ex. RUCO-8 at 7; Keene and Andreasen Settlement Report, Ex. S-19 at 2). Eliminating these schedules would have had a disproportional impact on those customers, who may have experienced increases merely by switching to other rate schedules, in addition to the rate increases allocated to those schedules. (Stutz Cross-Rebuttal Test., Ex. RUCO-8 at 7). Preserving Schedules E-10 and EC-1 mitigates the disproportional impact on the affected customers. (Diaz Cortez, Tr. at 1308-09). APS will provide notice to customers on those schedules that those schedules will be eliminated in APS' next rate case. (Settlement Agreement at ¶ 114). However, to mitigate the rate impact of eliminating these schedules at that time, and to acknowledge that they produced lower returns than the remaining residential rate schedules, Schedules E-10 and EC-1 would receive slightly higher percentage increases than the other residential customers. (Keene and Andreasen Settlement Report, Ex. S-19 at 2). (4.82% compared to 3.8% for other residential schedules).

A second rate-design benefit to residential customers is the maintenance of certain terms of residential time of use ("TOU") pricing. Approximately 40% of APS' residential customers are on TOU pricing. (Rumolo, Tr. at 1302). APS had proposed to reduce the difference between off-peak and on-peak prices in the summer, and completely eliminate the TOU distinction in winter rates. Currently, APS' off-peak rate is about one-third of the on-peak rate, providing a strong incentive to shift usage to off-peak times. (Diaz Cortez, Tr. at 1309). APS' application had proposed to reduce that margin to about one-half, which would have decreased customers' incentive to shift their usage. Id. The Settlement Agreement maintains the existing ratio between off-peak and on-peak rates, thus maintaining the strong incentive to shift usage. Id. Moreover, the Settlement maintains the distinction of off-peak and on-peak pricing during the winter months. (Settlement Agreement at ¶ 116).

In addition, the Settlement Agreement provides for experimental TOU rates for residential customers to begin to address flexibility in peak periods. While the TOU schedules currently provide for on-peak hours of 9 a.m. to 9 p.m. during summer months, up to 10,000 customers will have the option of selecting an alternative on-peak period of 7 a.m. to 7 p.m. or 8 a.m. to 8 p.m. (Keene and Andreasen Settlement Report, Ex. S-19 at 2). Changing the peak hours requires actually changing out the TOU meters, which would cost an estimated $30 million if required for all residential customers. (Rumolo, Tr. at 1383-84). Rather than incurring such a significant expense, APS will use the data from these experimental rates to evaluate ways in which it can have more flexibility in implementing changes to its peak periods. (Andreasen, Tr. at 1312).

XIII. DISTRIBUTED GENERATION.

A. Specific Issues Associated with Distributed Generation Should be Addressed in a Workshop Devoted to Distributed Generation Issues.

The Arizona Cogeneration Association (AzCA) has opposed the Proposed Settlement, because in its view, the Agreement does not produce results that are favorable enough for distributed generation ("DG"). Many of the issues raised by AzCA, including interconnection standards and rate design for partial requirements service, are best addressed in a Commission-authorized workshop process that is governed by a strict timetable for producing recommended actions for the Commission.

Paragraphs 108 and 109 in the Settlement Agreement direct the Commission Staff to schedule workshops to address outstanding distributed generation issues. Such a process would allow interested parties and Staff the opportunity to utilize previous work that has been developed with respect to distributed generation and to address the technical aspects of connecting distributed generation in a manner applicable to all regulated utilities in Arizona. (Rumolo, Settlement Rebuttal Test., Ex. APS-2SR at 3-5). By establishing a strict timetable for producing recommended actions for the Commission, the proposed workshop can avoid the outcome of the previous distributed generation workshop of four years ago, in which analysis was performed, but no formal recommendations to the Commission were made. (Keene, Tr. at 1574-76).

AzCA Exhibit 9 was a slide presentation of AzCA's position in this proceeding. One of its pages was entitled "SOLUTION" and essentially indicated the following objectives of the AzCA:

a) a DG workshop with strong staff leadership;

b) clear goals, ground rules, milestones, and deadlines;

c) participants with authority;

d) continuing reports to the Commission and to management (of the participants); and

e) a process to bring contested issues to Commission for resolution.

AzCA witness Murphy agreed that adoption of these objectives would satisfy the AzCA's concerns. (Murphy, Tr. at 1543-44). The Parties do not oppose Commission adoption of the above-stated objectives relative to DG in any final order approving the Proposed Settlement.

B. Schedule E-32 Should not be Redesigned to Meet the Specialized Needs of Partial Requirements Service, but Rather the Rate Design for Partial Requirements Service Should be Addressed in the Workshop.

AzCA's proposal to radically alter Schedule E-32 relative to the Proposed Settlement is the wrong approach to resolve issues concerning partial requirements service. The record amply demonstrates that many of AzCA's claims regarding Schedule E-32 are vague, confusing, and factually incorrect. AzCA's proposals with respect to Schedule E-32 should be rejected by the Commission. (Rumolo Settlement Rebuttal Test., Ex. APS-2SR at 2, 7-15; Higgins Responsive Test., Ex. AECC/PD/FEA/K-2 at 2-10; Higgins, Tr. at 1632-33).

Schedule E-32 serves approximately 95,000 *full* requirements customers – constituting over 90 percent of APS' General Service customer base. The design of Schedule E-32 is an integral part of the Settlement Agreement. AzCA's proposal to place all of the rate increase for Schedule E-32 on the energy charge – while ignoring the demand charge – would create a massive subsidy from higher-load-factor customers to lower-load-factor customers, eviscerating the benefits of the Proposed Settlement for several of the Parties. The demand-related charges in Rate E-32 are necessary for properly pricing the capacity-related costs of the APS system for these full requirements customers. These charges are critical for properly assigning fixed distribution and generation costs to these thousands of customers, to ensure that they are appropriately charged for the costs they cause to be incurred. (Higgins Settlement Responsive Test., Ex. AECC/PD/FEA/K-2 at 5; Higgins, Tr. at 1630).

Distributed generation, on the other hand, requires *partial* requirements service. This is a very specialized product that includes subcomponents such as maintenance power, standby power, and supplemental power. Partial requirements service should have a rate that is tailored to its special needs. The rate design of this specialized service is more properly addressed in the proposed distributed generation workshop, where it can receive the attention and emphasis it requires. (Higgins, Tr. at 1630).

XIV. THE COMMISSION SHOULD TERMINATE THE PRELIMINARY INQUIRY, AND APS SHOULD DISMISS THE LITIGATION RELATED TO THE COMMISSION'S TRACK A ORDER.

The Settlement Agreement proposes to resolve these matters by eliminating both the preliminary inquiry initiated by the financing case, Decision No. 65796 dated April 4, 2003, and the APS litigation related to the Track A order. Resolving both the court cases and the Preliminary Inquiry will eliminate risky, protracted, and complicated proceedings; it will also allow the Commission, APS, and other interested parties to focus upon problem solving for the future, instead of litigating the propriety of past events.

APS has agreed to forever forego recovery of the $234 million write-off recorded at the time of the 1999 settlement agreement. APS has also agreed to dismiss its pending litigation against the Commission and to forever forego any claim that APS, PWEC, Pinnacle West Capital Corporation, or any of its affiliates were harmed by the Commission's Track A or Track B decisions. Staff recognizes that, if APS or its parent, Pinnacle West Capital Corporation, were to succeed in any of these lawsuits, APS' ratepayers may have to bear significant costs. Dismissal of this litigation would eliminate these potential risks to ratepayers.

Staff believes that it is appropriate to terminate the Preliminary Inquiry that was initiated by the Commission as a result of certain concerns raised during the course of the financing case. APS addressed these concerns both in a detailed report filed with the Commission on June 13, 2003 and in its Rebuttal Testimony. Moreover, the revised APS Code of Conduct, filed with the

Commission in October of 2002 in response to the Track A Order (Decision No. 65154 (September 10, 2002)) will be reviewed by Staff and the Commission in a separate proceeding following the conclusion of this rate proceeding. *See* Procedural Order in the Track A Docket dated October 28, 2003. At that time, any ongoing issues as to APS affiliate relations can be considered and resolved.

XV. THE APS SERVICE SCHEDULES AGREED TO BY THE PARTIES IN SECTION XIV OF THE PROPOSED SETTLEMENT, AND ATTACHED THERETO AS APPENDICES C THROUGH H, ARE JUST AND REASONABLE.

The Settlement Agreement provides for modifications to APS' Service Schedules. (Proposed Settlement at ¶¶ 97 through 102). The Company's retail tariff consists of a series of Rate and Service Schedules. Rate Schedules (e.g., E-12 or E-32) consist of specific prices for electric service and a description of the eligibility criteria for the Schedule and/or the type of service (e.g., single or three-phase) provided under the Schedule. Service Schedules, on the other hand, provide definitions of tariff terms, identify Company and Commission requirements (both general and specific) regarding the provision by APS of electric service, and Commission-authorized charges for miscellaneous services such as service connection, line extension, etc. These Service Schedules include the following:

- Schedule 1 – Terms and Conditions for the Sale of Electric Service
- Schedule 2 – Terms and Conditions for Energy Purchases from Qualified Cogeneration and Small Production Facilities
- Schedule 3 – Conditions Governing Extensions of Electric Distribution Lines and Services
- Schedule 4 – Conditions Governing the Totalized Metering of Electric Loads
- Schedule 5 – Guidelines for Electric Curtailment
- Schedule 7 – Electric Meter Testing and Maintenance Plan
- Schedule 10 – Terms and Conditions for Direct Access

- Schedule 15 – Conditions Governing the Providing of Electric kWh Pulses

In the original rate case Application, APS proposed changes to Schedules 1, 3, 4, 7, 10 and 15. The changes were supported by the Direct Testimony of APS witness David Rumolo. (Ex. APS-11). In general, the proposed changes to Schedule 1 consisted of modifying language to reflect improved business practices, small increases in customer-optional charges, and proposed new charges to recover costs of customer-requested services from customers who are actually requesting special services rather than from ratepayers at large. The proposed changes to Schedule 3 included changing the basis for individual residential line extensions from a footage basis to an investment allowance. For other extensions including extensions to subdivisions, the proposed Schedule 3 changes consisted of modifications to the economic studies used to examine the feasibility of extensions to reflect modern realities. The study modifications include recognizing the possibility of direct access by using only revenues and costs associated with the "wires" component of rates and recognizing the impact of dual-fuel options available to customers on the extension feasibility. The proposed modifications to Schedules 4, 7, 10 and 15 were primarily designed to reflect current and improved business practices. For example, existing Schedule 10 language addressed the introduction of Direct Access and is no longer required as the phase-in period for Direct Access is long over.

In Direct Testimony, Staff indicated that it accepted most wording changes in Schedule 1 but proposed alternative charges for services described in Schedule 1. (Keene Direct Test., Ex. S-4 at 19). Staff also recommended that APS continue to use a footage basis for individual line extensions as found in the existing Schedule 3. Id. at 24. Staff also proposed modifications to APS' request as to Schedule 10, but opposed APS' proposed changes to Schedule 7. The modifications to the former went from correcting typographical errors to clarification of the ownership of certain types of meter transformers to the charges to ESPs for the provision of certain customer data. As to the latter, Staff believed that the specific language of A.A.C. R14-2-208(E)(1) precluded APS' proposed adoption of any later version of ANSI standards other than the 1995 edition. Staff also believed that the term "meter maintenance and testing program" contained in the existing Schedule 7 was more consistent with A.A.C. R14-2-208(E)(2) than the Company's proposed use of the term "meter performance monitoring plan."

In Rebuttal Testimony, APS Witness Rumolo agreed with many of Staff Witness Keene's recommendations regarding the proposed changes to the Service Schedules and summarized the recommendations of APS, Staff and RUCO in Attachment DJR-1RB to his Rebuttal Testimony. (Ex. APS-9R). The Proposed Settlement generally adopts the Company's proposed Service Schedule changes as modified by Staff's recommendations, including Staff's recommended customer charges for Schedule 1, the continued use of the footage allowance for individual residential extensions as described in Schedule 3, and the changes to Schedules 7 and 10 discussed above.

XVI. CONCLUSION.

For the reasons set forth in this brief, the Parties request that the Commission approve the Proposed Agreement without modification.

RESPECTFULLY SUBMITTED this 14th day of January, 2005.

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