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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
DOCKETED
SEP 15 2006
DOCKETED BY

COMMISSIONERS

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MIKE GLEASON
KRISTIN K. MAYES
BARRY WONG

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 TO AMEND DECISION NO. 67744.	DOCKET NO. E-01345A-05-0816 **NOTICE OF FILING REBUTTAL TESTIMONY**

Notice is given that the Arizona Utility Investors Association has filed the Rebuttal Testimony of Julie M. Cannell on its behalf in the above-entitled docket. A brief summary of the Testimony is set forth at pages 1-2.

RESPECTFULLY SUBMITTED this 15th day of September, 2006.

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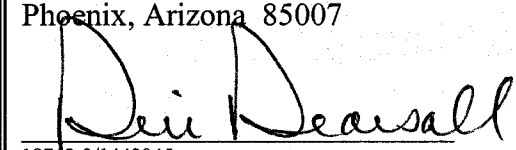

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REBUTTAL TESTIMONY OF JULIE M. CANNELL

On Behalf of the Arizona Utility Investors Association

Docket No. E-01345A-05-0816

September 15, 2006

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REBUTTAL TESTIMONY OF JULIE M. CANNELL
ON BEHALF OF ARIZONA UTILITY INVESTORS ASSOCIATION
(Docket No. E-01345A-05-0816)

Q. PLEASE STATE YOUR NAME AND BUSINESS AFFILIATION.

A. My name is Julie M. Cannell. I am president of J.M. Cannell, Inc.

Q. DID YOU PREVIOUSLY SUBMIT DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes. My direct testimony was submitted on behalf of the Arizona Utility Investors Association on August 18, 2006.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. I will respond to the return on equity ("ROE") and Power Supply Adjustor ("PSA") recommendations of the Arizona Corporation Commission Staff and the Residential Utility Consumer Office ("RUCO").

REBUTTAL SUMMARY

Q. PLEASE SUMMARIZE THE KEY POINTS OF YOUR REBUTTAL TESTIMONY.

A. While investors and, I believe, the rating agencies have responded or will respond positively to their positions on changes to the PSA, the respective 10.25% and 9.25% ROE recommendations of Commission Staff and RUCO do not meet the expectations of investors. As noted in my direct testimony, institutional investors specifying an ROE assumption for their earnings models originally weighed in at 11.5%, 10.5% and 10.25%. Recently published analyst reports providing ROE expectations brought the lower end of that range up to 10.5%. Further, it is likely that investors expect the final ROE award to be at the high end of that range given

the facts, among others, that: (1) Arizona Public Service Company ("APS" or "Company") financial position is weak; (2) the Company remains just one step above a non-investment grade rating; (3) the utility sector generally is viewed as more risky today than historically; and (4) interest rates are rising. A constructive ROE decision in this case—particularly in light of APS' enormous near-term capital needs—is absolutely vital. Should investors' expectations fail to be met on Pinnacle West's potential for growth in earnings and dividends, the cost of capital to the Company and the cost of service to ratepayers will increase dramatically.

POWER SUPPLY ADJUSTOR

Q. ARE INVESTORS CONCERNED ABOUT WEAKNESSES IN THE COMPANY'S CURRENT PSA MECHANISM AND ITS ABILITY TO RECOVER PRUDENTLY INCURRED FUEL AND PURCHASED POWER EXPENSES?

A. Yes. As I discussed in my direct testimony, fuel and purchased power cost recovery is a key issue for investors. A consistent theme throughout rating agency and analyst's negative reports and downgrades has been concerns about the Company's ability to recover on a timely basis this major cost element and need for improvements in the PSA. For example, after this Commission's Decision four months ago authorizing approximately $140 million in additional recoveries, Standard & Poor's stated it was maintaining APS' rating at just one level above non-investment grade premised upon the Commission "continuing to

provide sustained regulatory support that addresses permanent rate relief and manages the [PSA] deferral balances downward over a reasonable time frame."[1]

Q. IN THEIR TESTIMONIES, THE STAFF AND RUCO HAVE SUPPORTED CHANGES IN THE COMPANY'S CURRENT PSA MECHANISM. DO YOU BELIEVE THOSE CHANGES ARE RESPONSIVE TO INVESTORS' CONCERNS?

A. As I stated specifically in my direct testimony, I would stress that I am not familiar with the details of APS' PSA and its specific problems, but I believe Staff's and RUCO's positions are the kind of "sustained regulatory support" which investors are expecting. In the case of Staff's recommendations, UBS called them "Constructive suggestions on fuel cost recovery."[2] Bank of America expressed similar views: "[I]t is good to know that [Staff is] continuing to think about ways that could help narrow the regulatory lag between decisions and make the [PSA] mechanism more efficient."[3] While I'm not aware of any published comment on the RUCO PSA positions, I believe that its endorsement of three of the four changes to the PSA recommended by APS in its direct testimony was also viewed positively. The large unrecovered fuel and purchased power balances were a major contributing factor to the rating agency downgrades just a few months ago and it is vital that the Commission address them structurally in this case.

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[1] Standard & Poor's, "Summary: Arizona Public Service Co.," May 10, 2006.
[2] UBS, "The Rate Case Moves Forward," August 21, 2006.
[3] Bank of America, "Company News," August 21, 2006.

RETURN ON EQUITY

Q. ARE THE ROE RECOMMENDATIONS OF THE COMMISSION STAFF AND RUCO CONSISTENT WITH INVESTOR EXPECTATIONS?

A. Commission Staff Witness David Parcell proposed a 10.25% ROE and RUCO Witness Stephen Hill supported a 9.25% equity return. Neither is consistent with investors' expectations as to an appropriate ROE.

Q. HAVE INVESTOR EXPECATIONS CHANGED SINCE YOUR DIRECT TESTIMONY WAS FILED?

A. They have become slightly more optimistic about a positive outcome on this aspect of this case. As noted in my direct testimony, several investors expressly stated their expectations of ROE awards in this rate proceeding: Merrill Lynch, 11.5%; Lehman Brothers, 10.5%; and Citigroup, 10.25%. Importantly, Citigroup increased its ROE expectation from 10.25% to 10.875%, as a result of the Commission Staff's filed testimony. I believe that 10.5% now represents the floor of a range of expected allowances from 10.5% to 12% that investors consider to be reasonable. Lehman Brothers put it this way: "The [ROE] recommendations [of ACC Staff and RUCO] mark the likely worst case in this proceeding. We view fair treatment by the ACC as essential to APS' investment grade rating and attraction to equity investors."[4]

Q. HOW CRITICAL IS THIS CASE TO APS' FINANCIAL HEALTH AND ITS ABILITY TO DELIVER SERVICE TO CUSTOMERS AT REASONABLE RATES?

A. Very. As discussed extensively in my direct testimony, changes in the investment industry itself, its views of the risks of the utility sector generally and APS

[4] Lehman Brothers, "Pinnacle West Capital: Staff Testimony as Expected," August 21, 2006.

specifically as well as APS' need for large amounts of capital to finance system growth make this a uniquely important case. APS' credit metrics are shaky and it faces the very real and continuing risk of further downgrades to below investment grade. Lehman reinforced the critical importance of the current proceeding in its analysis of the Staff and RUCO recommendations: "Should the final order reflect financial parameters approximating these filings, it would be difficult for Arizona Public Service (APS), the utility subsidiary of Pinnacle West Capital Corp., to maintain investment grade ratings or provide support for the current stock value in our view. While Arizona has historically been a very difficult jurisdiction for investors, we look for a final ACC order in 2Q of 2007 to significantly improve upon Friday's [Staff and RUCO] filings."[5]

Q. WHY IS THE RANGE OF INVESTOR ROE FORECASTED OUTCOMES SO BROAD?

A. As discussed in my direct testimony, some investors are conservative in their assumptions about the ROE award. While the Commission Staff's recommendation was better than many had expected, analysts and rating agencies remain concerned about the supportiveness of Arizona regulation, particularly in the current climate of rising energy prices. I continue to believe that investors are erring on the side of conservatism in their projections regarding this case's outcome.

[5] *Ibid.*

Q. ALTHOUGH YOU BELIEVE THAT BOTH THE COMMISSION STAFF'S AND RUCO'S ROE RECOMMENDATIONS ARE BELOW THE LEVEL OF INVESTOR EXPECTATIONS, DO YOU DRAW ANY DISTINCTION BETWEEN THE TWO PROPOSALS?

A. Yes. Mr. Parcell's recommendation of 10.25% is far more sound and constructive than Mr. Hill's, and only slightly below the current level of investor expectations. In fact, Citigroup increased its ROE assumption from 10.25% to 10.875% on the basis of Staff's recommendation: "Staff's testimony regarding rate base, capital structure, and return were more constructive than expected. . . . . *We think Staff's testimony eases down-side of our previous "bid-ask" spread on earnings.* . . . Our forecast assumes that APS ultimately will earn a mid-point allowed ROE of 10.875% on a 54.5% equity ratio."[6] (Italics in original.)

Mr. Hill's proposed 9.25% ROE, however, does not even approach levels that investors would find acceptable. Additionally, Mr. Parcell supports the Company's actual capital structure which has a 54.5% equity ratio, while Mr. Hill proposes a hypothetical equity ratio of only 50%.

Q. PLEASE COMMENT ON THE RATIONALE MR. HILL OFFERS FOR CONCLUDING THAT A 9.25% ROE WOULD BE REASONABLE FOR APS.

A. In my opinion, Mr. Hill's basic premise of the Company having lower financial risk than a peer group is faulty. His testimony states: "I have estimated the equity capital cost of integrated electric utility companies to fall in a range of 9.25% to 9.75%. Within that range, I estimate the equity cost of the Company's

[6] Citigroup, "Pinnacle West Capital Corporation: PNW: Staff GRC Testimony Looks Constructive; Raising Target Price," August 21, 2006.

electric utility operations to be at the lower end of a reasonable range of equity costs for electric utilities due to the Company's lower financial risk—9.25%"[7]

Q. DOES MR. HILL'S <u>LOWER</u> FINANCIAL RISK ASSESSMENT ACCURATELY REFLECT THE VIEWS OF CREDIT RATING AGENCIES AND INVESTORS?

A. No. It totally disregards reality as well as the expressed opinions of credit rating agencies and investors. The Company is perilously close to a further credit rating downgrade which would place it in non-investment grade territory. As well, rating agencies and equity analysts perceive considerable regulatory risk for the Company which only adds to the financial risk. A higher risk level argues for a higher ROE, not a lower one. Mr. Hill's recommendation is precisely <u>not</u> the outcome that investors want to see from the Commission in this case. As my direct testimony noted, analysts were encouraged by the Commission's May 2 Decision in the Company's emergency rate case, but indicated they are watching closely for a continuation of constructive regulatory treatment. Adoption of Mr. Hill's 9.25% recommendation clearly would not be regarded as supportive.

Q. WHAT IMPACT WOULD A DISAPPOINTING ROE DECISION LIKELY HAVE?

A. An equity return decision that investors consider to be subpar would have a very deleterious impact. An inadequate outcome for risk compensation would most likely result in their unwillingness to extend capital, or to make it available at reasonable prices, during a period when APS will frequently need to access the capital markets for billions of dollars. That result will be bad for the Company

[7] Stephen G. Hill, Direct Testimony on Behalf of the Residential Utility Consumer Office, August 18, 2006, p. 3.

1 and the customer. Both are negatively impacted when APS can't access the debt
2 and equity markets on reasonable terms. With unnecessarily weak financials, the
3 Company's need to access the capital markets could become greater as the risk of
4 credit downgrades becomes even more pronounced, which, in turn, results in a
5 vicious negative cycle. That inadequate return would force the Company to
6 return prematurely to the Commission with the need for another rate increase.

7 **Q. DOES THIS COMPLETE YOUR REBUTTAL TESTIMONY?**

8 A. Yes.