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October 6, 2006

Docket Control
Arizona Corporation Commission
1200 west Washington
Phoenix, Arizona 85007

RE: WITNESS SUMMARIES OF DIRECT, REBUTTAL AND REJOINDER TESTIMONY UNDER DOCKET NOS. E-01345A-05-0816, E-01345A-05-0826 AND E-01345A-05-0827

Dear Sir or Madam:

Pursuant to the procedural oder dated April 5, 2006, in the above referenced Dockets, Arizona Public Serivce Company ("APS") is hereby filing written summary for William E. Avera. Theresa A. Orlick and Barbara D. Lockwood.

If you or your staff have any questions, please feel free to call me.

Sincerely,

Brian Brumfield
Supervisor
Regulatory Affairs

BB/rdp

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SUMMARY OF TESTIMONY GIVEN BY WILLIAM AVERA

I. DIRECT. (As Amended by January 31, 2006 Filing)

The purpose of my testimony is to present to the Arizona Corporation Commission ("ACC" or the "Commission") my independent assessment of the fair rate of return on equity ("ROE") for the jurisdictional electric utility operations of Arizona Public Service Company ("APS" or the "Company"). In addition, I also examined the reasonableness of APS' requested capital structure, considering both the specific risks faced by APS and other industry guidelines.

Based on the results of my analyses and the economic requirements necessary to support continuous access to capital, I recommend that APS be authorized a fair rate of return on equity of 11.5%. This return is appropriate when considering investors' expectations for capital markets, the substantial funding requirements faced by APS, and the need to support financial integrity and fund crucial capital investment, even under adverse circumstances. It is my opinion that 11.5% is a reasonable ROE for APS. Indeed, my analyses implied that when alternative quantitative methods are applied to a proxy group of other electric utilities operating in the Western U.S. the cost of equity range is 10.8% to 11.8%, before considering an allowance for flotation costs. In evaluating my suggested ROE, the Commission should also consider the likelihood of higher interest rates.

As for equity flotation costs, I contend that it is important to incorporate a 20 basis-point allowance. When considered in the context of the electric utility proxy group discussed above, this allowance resulted in a fair rate of return range between 11.0% and 12.0%. My suggested 11.5% ROE falls in the midpoint of this range, representing a reasonable rate of return on common equity for APS. With respect to the reasonableness of the company's capital structure, I also concluded that a common equity ratio of approximately 55% represents a reasonable basis from which to calculate APS' overall rate of return.

Moreover, I determined that APS' requested capitalization is consistent with the Company's need to strengthen its credit standing and financial flexibility as it seeks to raise additional capital to fund significant system investments and meet the requirements of its growing service territory. As such, APS' proposed common equity ratio is consistent with expectations for electric utilities in the proxy group. These common equity ratios were then used to estimate the cost of equity. However, in order to achieve a proper common equity ratio, regulatory support for higher equity levels is necessary. Such support will allow APS financial flexibility and preserve the Company's capacity to fund investments that ensure reliable service and facilitate further development of electric utility infrastructure in Arizona.

II. REBUTTAL.

Mr. Parcell's 10.25% ROE recommendation is significantly downward-biased and Mr. Hill's 9.25% cost of equity is completely out of touch with the requirements of investors in the capital markets. My rebuttal details the shortcomings that lead Mr. Parcell and Mr. Hill to underestimate investor requirements. Moreover, I document that quantitative methods identical to those used by the ACC Staff, and adopted by this Commission, imply a ROE of 11.20% for APS, prior to considering flotation costs. While Mr. Parcell accepts APS' requested capital structure, Mr. Hill combines his low ROE with a capital structure that has less equity than APS actually maintains. As such, Mr. Hill's phantom capital structure makes RUCO's position more extreme, amplifying the implicit financial damage that accompanies his recommendations. My Rebuttal Testimony demonstrates that Mr. Hill's rationale for adjusting the capital structure is based on false premises and is inconsistent with industry practice and rating agency requirements.

In addition, Mr. Parcell and Mr. Hill's recommendations are untenable in their practical application. These witnesses recommend returns lower than what other utilities are currently authorized—something documented in their own sources. Furthermore, both witnesses recommend that the ACC allow APS a return below the average ROE allowed by other commissions in recent months. Their recommendation ignores the unique risks and challenges facing APS, such as a weakened credit rating, substantial funding needs, regulatory lag, and increasing costs. Providing APS with the opportunity to earn a return that reflects these realities is an essential ingredient to strengthen the Company's financial position. Moreover, allowing an adequate ROE will ultimately benefit customers by ensuring the Company's continued ability to meet customers' needs at lower long-run costs. The Staff and RUCO recommendations are out of line with investor requirements and regulatory practice. Adopting them would send an alarming signal to the investment community at this critical juncture for APS. If investors lose confidence in the Company, customers and the Arizona economy would suffer.

In addition to the low ROE recommendations, there is a fundamental flaw in Mr. Parcell and Mr. Hill's testimonies. Both witnesses agree that sound economics and the *Hope* and *Bluefield* cases require that the end result of return recommendations be tested against the standards of maintaining financial integrity, access to capital, and adequate compensation for risk. Even if the methods they use to test the end results were correct (and my rebuttal demonstrates that they are not), <u>both witnesses wrongly assume that APS will actually earn their allowed return</u>

recommendation. However, attrition will prevent APS from having an opportunity to actually earn its allowed ROE. Indeed, SFR Schedule F-1 of APS' January 31, 2006 filing ("Schedule F1") demonstrates that even if the Company was allowed my 11.5% recommendation, and the new rates became effective on January 1, 2007, the earned return for 2007 would fall to 9.8%.

As explained in my Rebuttal Testimony and the Rebuttal Testimonies of Mr. Brandt and Mr. Wheeler, the relentless forces of growth, new capital investment, inflation, and unrecovered costs, combined with regulatory lag, will drive APS' earned return well below the allowed ROE. Investors focus on what will actually be earned, not the promise of an allowed return that will erode with attrition. As a result, the financial indicators calculated by Mr. Parcell and Mr. Hill, which assumed their recommended return is actually earned, are exercises in financial fiction—they have no meaning in the real world in which capital must be raised. My Rebuttal Testimony proposes an attrition adjustment to ROE of at least 170 basis points, giving APS an opportunity to maintain its financial integrity, preserve the ability to attract capital, and offer investors a return commensurate with risk.

III. REJOINDER.

In response to the Rebuttal Testimony of Staff and RUCO, my Rejoinder Testimony emphasizes the necessity to ensure that the ROE for APS meets the end-result test required by regulatory policy, with the specific risks and challenges faced by APS justifying an ROE that exceeds the historical average for other utilities. Moreover, because the end-result test must consider the utility's actual ability to earn the allowed rate of return, it is imperative to consider the impact of attrition when establishing an ROE for APS. Finally, I concluded that my reference to the methods previously adopted by the Commission serves as a useful benchmark in evaluating the reasonableness of Staff's and RUCO's ROE recommendation in this case. The fact that Staff's recommended ROE for APS falls *below* what was approved by the ACC in August 2006 for a lower-risk water utility illustrates the fact that Mr. Parcell's recommendation is significantly downward-biased.

SUMMARY OF TESTIMONY GIVEN BY TERESA ORLICK

II. REBUTTAL.

In accordance with Decision No. 67744, APS filed a Demand Side Management ("DSM") Portfolio Plan consisting of 10 proposed programs on July 1, 2005. The programs were developed with input and review from the DSM Collaborative working group. These residential, non-residential, and low income programs were approved by the Commission in three separate open meetings, between August 2005 and April 2006 and are budgeted to spend $48 million by year-end 2007. APS does not believe that $48 million will be spent by year end 2007 due to the delayed approval of the programs and the steep ramp-up from a level of $1 million prior to Decision No. 67744 to the current level of $16 million per year of DSM spending. Furthermore, the new construction element of the programs is likely to extend past 2007.

Intervenor Southwest Energy Efficiency Project ("SWEEP") has proposed aggressive modifications to current DSM requirements. APS believes it is premature to make substantial changes to the DSM program including the imposition of a kWh and kW savings target. A savings target is unnecessary because APS already has an approved DSM spending requirement that delivers energy savings. SWEEP also proposes an Energy Efficiency Standard ("EES") which includes a proposed spending level that is very aggressive, representing nearly 2.5% of revenue. For the year 2007, the proposal would represent a $28 million increase over base rates and a $22 million increase over the target level of $16 million.

Because long range results are very difficult to predict, APS believes a 12-Year EES Implementation Plan proposed by SWEEP would have little actionable value in planning or implementation. Updates based upon shorter term planning horizons result in a more actionable plan.

In addition, an alternate DSM funding mechanism is not needed in this rate case. The current approach, with a combination of base rates and the DSM adjustor mechanism provides a flexible means of cost recovery, which can adjusted between rate cases as needed.

APS agrees with Staff that the performance incentive is appealing as a tool to reward a utility's performance in conducting successful DSM programs. APS also agrees with the following Staff recommendations: 1) performance incentive share should be set at 10% of the net benefits; 2) incentive should be capped at 10% of spending inclusive of performance incentive; 3) APS should share in benefits of

DSM measures as they are placed into service and expenditures are incurred; and 4) APS should include a request for the performance incentive payment in each semi-annual report filing.

APS recommends that program savings should be based on the program filed savings numbers until such time that Measurement, Evaluation and Research ("MER") results are available. It is important to clarify that the program filed savings reflect actual savings from field measurements collected over many years of energy efficiency program implementation, in environments representative of our service territory.

APS supports the concept of mitigating the heat island effect in metropolitan areas as evidenced by APS' sponsorship of the ASU Global Institute for Sustainability, through its Sustainable Materials and Renewables Technologies Alliance, and as a Sustainer/Lifetime contributor to this effort. APS is willing to bring outside experts together to inform and educate the DSM collaborative group on heat island effect. Current DSM programs sufficiently cover components of the heat island effect so that a separate and distinct program is not needed at this time.

APS Energy Support Program, "E-3" offers discounts up to 40% off the cost of electricity for customers who meet certain income guidelines. The E-4 program incorporates a medical care equipment program which provides additional discounts to eligible customers who qualify for the E-3 discount. Once a year, APS sends program information and applications to all residential customers not already enrolled in E-3 and E-4. This solicitation includes a postage prepaid return. Applications are also distributed at APS offices, social service agencies and are downloadable on aps.com.

In April 2006, Decision 68685 (APS Emergency Rate Case) requested APS to propose ways to implement automatic enrollment into our low-income programs for customers who participate in applicable means-tested assistance programs. APS has an Electronic Agency Guarantee website that allows authorized community agencies to verify a client's account data, and post a payment guarantee from various assistance programs, including the federal Low Income Home Energy Assistance Program ("LIHEAP"). On June 1, 2006, APS initiated a pilot program to test the concept of utilizing this website as a means to automatically enroll LIHEAP candidates into APS' E3 program. Now, when a customer goes to a community action agency and is eligible for LIHEAP assistance, the caseworker informs the client that they can also enroll in APS' E-3 Low Income program and receive a discount on the cost of their electricity.

APS sends program promotions via customer bills to all residential customers every year and applications are always available at Community Action Agencies and government economic assistance offices. APS promoted the programs via articles in the April/May 2005, October/November 2005 and June/July 2006 APS "Arizona Lifestyle" newsletters, and expanded information on aps.com, including an on-line application for customers . APS is reaching out to numerous agencies to enlist them as partners in promoting E3. APS is also reaching out to Tribal customers to increase their participation in E3. E3 participation has increased from approximately 28,000 during the test year, to over 36,000 by August of 2006, while participation among Tribal customers has increased 150% over the same period.

III. REJOINDER.

APS agrees with the proposal provided in Staff's surrebuttal testimony (JD Anderson, page 3 line 23 through page 4 line 13) regarding the DSM Performance Incentive. In particular, APS agrees with using the measured savings developed by the MER contractor to determine the net benefits of the DSM Portfolio starting with the second semi-annual DSM report for 2007. Prior to that period, APS will use current and regionally similar figures for the energy savings to determine the DSM Portfolio net benefits. There may be instances where the program-filed savings numbers are the most current and regionally similar.

Actual spending January 2005 through August 2006 totaled $6.7M. At this time, we estimate that spending for the remainder of 2006 will reach $5.9M, for a total program spending through year-end 2006 of $12.6M. We will have saved, in annual terms, over 127,000 MWh resulting from this DSM spending and the corresponding DSM measures installed in 2005 and 2006. Mr. Ewen provides an updated estimate of the financial impact of these reduced sales in his Rejoinder Testimony.

Summary of Testimony Given By
Barbara D. Lockwood

I. Direct. (As Amended by January 31, 2006 Filing)

None filed.

II. Rebuttal

APS supports the goal of increasing the use of renewable resources to meet customers' growing energy needs and believes the RES proceeding is the appropriate forum to discuss this issue. APS believes that increasing the usage of renewable energy is a worthy objective for many reasons. The Company supports the intent of the draft RES and believes that the RES rulemaking is the proper forum for addressing renewable energy. In addition, APS has proposed green power schedules and the Total Solar schedule that provide additional customer choice.

APS anticipates obtaining most of our renewable energy for the RES from bulk power purchase of renewable energy or through generation of renewable energy from APS-owned projects. For distributed energy, APS believes customer awareness will be fundamental to the success of our program. APS also plans to incorporate the Uniform Credit Purchase Program.

APS does not believe an independent evaluator proposed by Ms. Ormond is necessary since the draft RES requires procedures for resource selection to be certified by an independent auditor as fair and unbiased. APS also believes that mandated RFPs are not in our customer's best interest.

APS also proposes modifying our Green Power Schedules. APS' modified proposal is to provide energy from a mix of renewable resources representing our available portfolio using three specific contracts. Finally, APS is proposing a new Total Solar Schedule which offers customers the opportunity to support solar energy by purchasing APS-generated solar energy to offset 50% or 100% of their energy consumption.

III. Rejoinder

The purpose of our Total Solar schedule is to offer solar energy to customers who are not able to, nor desire to, install a solar system at their home or business, as required by our Solar Partners Incentive Program. APS will install, maintain and operate a system for those customers. APS' objective is to provide a choice for our customers. The $0.39 per kWh is the cost for APS to install and operate the photovoltaic systems and included in this price are a combination of capital and financing as well as operation and maintenance expenses. In developing the rate, APS selected the most cost effective photovoltaic system available to us today.

APS believes that it is possible to get lower unit cost for solar energy from concentrating solar plants, assuming the project is in the 50 to 250 megawatt range with APS making a commitment to a long term power purchase agreement. A project sized at less than 50 MW would not be able to capture the necessary economies of scale, and 50 MW is a large financial commitment. APS could explore a long term contract with a third party for the installation, operation and maintenance of an appropriately-sized solar installation. APS is ineligible for the federal investment tax credit, but another entity could potential use the credit to reduce the overall cost to the ratepayer.

An Independent Evaluator is not necessary. Under the Renewable Energy Standard, it is Staff's intent to assure oversight of the procedures and processes associated with resource selection and the Recommended Order retains the provision that requires certification by an independent auditor. APS will work with the independent auditor to review our processes and procedures *before* applying them to select a resource. APS fully anticipates reporting on all renewable energy activities in its annual EPS/RES compliance report and obtaining certification for all resource selection.

Finally, the energy provided through our Green Power schedule will be in excess of the EPS/RES and Decision No. 67744 requirements.