0000065387

ORIGINAL

05

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MIKE GLEASON
KRISTIN K. MAYES
GARY PIERCE

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 NOS. E-01345A-05-0816 E-01345A-05-0826 E-01345A-05-0827

RECEIVED
2007 JAN 22 P 3: 35
AZ CORP COMMISSION
DOCUMENT CONTROL

GALLAGHER & KENNEDY, P.A.
2575 E. CAMELBACK ROAD
PHOENIX, ARIZONA 85016-9225
(602) 530-8000

Initial Brief
on Behalf of
Arizona Utility Investors Association

January 22, 2007

Arizona Corporation Commission
DOCKETED
JAN 22 2007

DOCKETED BY	NM

GALLAGHER & KENNEDY, P.A.
2575 E. CAMELBACK ROAD
PHOENIX, ARIZONA 85016-9225
(602) 530-8000

TABLE OF CONTENTS

GALLAGHER & KENNEDY, P.A.
2575 E. CAMELBACK ROAD
PHOENIX, ARIZONA 85016-9225
(602) 530-8000

The Arizona Utility Investors Association ("AUIA" or the "Association") submits this Initial Brief in relation to Arizona Public Service Company's ("APS" or the "Company") application for a rate increase.

INTRODUCTION

While the hearing phase of this proceeding was underway, Arizona got the news that it has surpassed Nevada and has now become the fastest growing state in the Union. The news was met with mixed emotions. For those of us who have been here for some time, it means more cars, congestion and, undoubtedly, longer waits in grocery stores and restaurants. On the other hand, what brought many of us to this State and what continues to bring hundreds of thousands more are the opportunities which growth brings. In many respects, this is a classic study in danger and opportunity.

Arizona's Legislative and Executive branches continue to focus on ways to minimize growth's dangers and maximize its opportunities. Last session, for example, the Legislature set aside an additional $300 million to accelerate highway construction. In her State of the State address earlier this month, noting that by the time her speech concluded there would be 20 new Arizonans, the Governor devoted much of her time to "foundation" proposals—a series of strategies to build and protect infrastructure.

APS is Arizona's largest utility. It is charged with the duty of securing the debt and equity capital needed to construct and maintain the most vital part of that infrastructure—the electric grid—as well as purchasing or generating the electricity necessary to meet the rapidly growing demands of the State's industries, businesses and homes.

The challenges are daunting. Over the next five years, the Company's capital expenditure budget will total almost $3.5 billion or $900 million annually.[1] Generation, distribution and general plant expenditures alone will require $700 million each year—annual expenditures which are more than double and triple the annual capital outlays APS incurred during construction of Palo Verde in the 1980s.[2]

The dangers are even more apparent—industry wide and APS specific. Based on her 20 years of experience as a utilities analyst and portfolio manager, AUIA witness Julie Cannell explained that "investors no longer perceive electric utilities as a group as being the 'safe havens' they once were... Consequently, investors now require a higher return for investing in the electric utility industry to balance the increased risk associated with it." Institutional investors today hold approximately 75-80% of APS's parent total common shares and are "now prone just to sell their shares on the news of an adverse regulatory outcome. This is not good for retail electric customers..."[3]

Hedge funds exacerbate the situation because "when they become disenchanted, their tendency is to sell quickly and without remorse...if hedge funds decide to make moves on Pinnacle West's shares based on the order in this proceeding, they will begin to do so within hours of the release of the order."[4] Former Michigan PSC Chairman and Fitch Managing Director Steven Fetter put it this way: "current utility investors...risk radar is set at a much lower tolerance level today."[5]

---

[1] APS Exhibit 27.
[2] Wheeler Hearing Testimony, TR Vol. I, pp. 112-113.
[3] Cannell Direct, AUIA 1, p. 8, ll. 10-22.
[4] *Id.*, p. 14, ll. 7-9 and p. 15, ll. 5-20.
[5] Fetter Direct, APS 23, p. 15, ll. 17-18.

For APS specifically in the past year, all three credit ratings agencies have downgraded the Company's bond ratings. Standard and Poor's has increased the Company's business risk profile and reduced its credit rating to the final notch above "junk" status. A critical metric remains in non-investment grade territory. Moody's Investor Services maintains a negative outlook on APS—specifically citing the credit challenge of "increasing amounts of capital expenditures" and the requirement of significant rate increases "to recover costs associated with capital investments as well as increased expenses for fuel and purchased power."[6]

The Company and its customers have already begun to feel the effects. APS can no longer count on daily liquidity as a result of the downgrades.[7] The elevation of the Company's business risk profile and drop to BBB- has increased borrowing costs. The ultimate cost to Arizonans of just one more downgrade to "junk" status could amount to $1.3 <u>billion</u> in the next ten years.[8] Our population is expected to double in just over 20 years. It is exceedingly dangerous to leave its largest utility knocking at the door of a non-investment grade rating.

For the State's fourth branch of government, this case presents a critical opportunity for the Commission to insure that APS is given the financial tools to meet these challenges and avoid these dangers. The nearly 7,000 members of AUIA who have debt and equity investments in APS and other utilities are vitally interested in the outcome, as are the Company's more than one million customers. Their interests are not at odds:

> When debt and equity investors charge less for their capital, utility rates remain lower. Thus, a utility and its electric customers have a shared interest in meeting the expectations of investors and credit rating agencies.[9]

---

[6] AUIA 1, p. 18, ll. 19-21.
[7] Brandt Hearing Testimony, TR Vol. IV, p. 719.
[8] Brandt Direct, APS 4, p. 4, ll. 9-23.
[9] AUIA 1, p. 6, ll. 2-4.

The Association has primarily focused its attention on certain key areas pertaining both to APS's earnings quantity and quality and will continue to do so in this Initial Brief:

1. Authorization of an 11.5% return on common equity and, to afford APS a reasonable opportunity to earn it, an additional 1.7% attrition adjustment;

2. Adoption of the Company's requests for a Construction Work in Progress allowance and an across-the-board annual increase of $50 million in allowed depreciation expense; and

3. Approval of Staff's "forward looking" Power Supply Adjustor.

Each of these recommendations is directly responsive to Chairman Hatch-Miller's request for "measures the Commission could take in helping APS gradually improve its creditworthiness."[10]

RETURN ON EQUITY

Dr. William Avera has recommended an 11.5% return on common equity ("ROE"). Although he discussed at hearing a more recent update of his original analysis which supported a higher ROE conclusion, he testified originally and maintained the position that:

> 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.[11]

Dr. Avera's 11.5% ROE recommendation fell at the midpoint of the range for a proxy group of other electric utilities operating in the western United States. He offered three additional justifications as to why that's a fair, albeit conservative, return on equity for APS, particularly in light of current circumstances:

---

[10] Chairman's July 21, 2006 letter to this Docket.
[11] Avera Direct, APS 41, p. 3, l. 24-p. 4, l. 2.

Capital Market Expectations: "I think capital market expectations is both a macro, a large issue of what investors expect in the future, for example, the general expectation of rising long-term interest rates. This morning [October 24, 2006] we hit a five-week high in long-term interest rates.*** And then I think there's also market expectations as they apply directly to APS, which includes, for example, the circumstances that APS faces of enduring attrition, having a significant capital budget, operating in a regulatory environment that has recently been constructive but still generally takes a long time to react."

Potential Exposures Faced by APS: "I was thinking specifically of the downgrade possibility or other events. One of the problems of being a low-rated utility is that if capital is tight, if you have a credit crunch, the low-rated companies are the ones that get left out.*** [T]he circumstance we have now is investors have lots of utilities out there that aren't facing [APS's] kind of financing challenges, that aren't facing this kind of growth. So if they are adverse to that kind of risk, they have plenty of places to put their money."

Economic Requirements: "The economic requirements are that investors have a choice where to put their money. They don't have to buy APS bonds. They don't have to buy Pinnacle West stock.*** Just before coming over here, I updated my analyses that I did in January, and basically the returns are 50 to 100 basis points higher. The DCF goes to 10 from 9. The capital asset pricing model goes to 13.3 from 12.6. So as markets offer higher returns, then APS must offer commensurate returns or else it will not be able to raise capital."[12]

In other words, in addition to traditional DCF, Risk Premium and CAPM analyses, Dr. Avera performed a current and real-world assessment of what investors expect given the depressed credit ratings, low earnings, growth challenges and dangers faced by APS. Although we tend to think of ROE as only an equity issue, Mr. Brandt discussed the fact that Dr. Avera's recommended 11.5% ROE is important to the debt market and rating agency actions as well: "Certainly an adequate return on equity, a strong return on equity is sort of a barometer of overall financial health..."[13]

Ms. Cannell presented an extensive review of investor expectations which support the 11.5% ROE award noting, among other things, that Lehman Brothers' projections for industry

[12] Avera Hearing Testimony, TR Vol. IX, p. 1859, l. 10-p. 1864, l. 1.
[13] Brandt Hearing Testimony, TR Vol. II, p. 398, ll. 8-10.

allowed returns, 2006 through 2010, are 11.3%.[14] On rebuttal, the former utility fund portfolio manager again stressed the importance of an adequate award:

> [I]nvestors expect the final ROE award to be at the high end of that range [11.5%] given the facts, among others, that: (1) [APS's] 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' 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.[15]

Staff and RUCO have recommended 10.25% and 9.25% ROEs, respectively. To place that in perspective, less than two years ago, the Commission authorized a 10.25% ROE in Decision No. 67744. Since that time, APS's business risk profile has increased, all three ratings agencies have downgraded, APS's critical FFO to Debt metric remains in non-investment grade territory, the Company sits one notch above a junk bond rating and it has a negative outlook from Moody's. Yet, Staff and RUCO ask the Commission to conclude that investors expect either the same or actually less risk compensation than they did in April 2005. Lehman Brothers offered this blunt appraisal of that premise:

> 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. Should the final order reflect financial parameters approximating these filings, <u>it would be difficult for Arizona Public Service...to maintain investment grade ratings or provide support for the current stock value</u> 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. (Emphasis supplied.)[16]

---

[14] AUIA 1, p. 28, ll. 1-3.
[15] AUIA 2, p. 1, l. 24-p. 2, l. 9.
[16] AUIA 2, pp. 4-5, quoting Lehman Brothers' August 21, 2006 report.

In addition to the 11.5% ROE, an equally important measure to help APS gradually improve its creditworthiness is a 1.7% attrition allowance to afford the Company some opportunity to actually earn its authorized rate of return. Both historic achieved returns and projections leave no doubt that APS will not have that opportunity absent an attrition allowance. For example, less than 15 months after the Commission authorized a 10.25% ROE, APS's actual return on capital was only 5.7% as of June 30, 2006.[17] The Commission has previously authorized a much larger explicit attrition adjustment, when APS's capital requirements were less than they are today and its creditworthiness was considerably stronger.[18]

Dr. Avera testified that a 1.7% allowance is very conservative in light of APS's 2003-2006 actual earnings experience of 200-400 basis points and more below the authorized return[19] and, in response to a question from Commissioner Gleason, discussed its "market" value as well:

> [T]he fact that APS is BBB-minus and that the rating agencies in their writings have explicitly said they're concerned about attrition, I think that makes it important for the Commission to send the signal or demonstrate to the rating agencies and all of the investors generally that you understand the problem and are willing to support.[20]

Mr. Fetter stated the same conclusion—stressing that the "attrition adjustment may have the best solidifying effect on the credit rating with the potential for improvement."[21]

Staff and the Company agree that the ROE should be applied to APS's present capital structure of 54% equity and 46% long-term debt.[22] On Staff's recommendation, the Commission unanimously approved the equity infusions from Pinnacle West to APS which produced this capital structure in Decision No. 68295. In that decision, Staff concluded that the equity infusion

[17] Brandt Rebuttal, APS 5, DEB-9RB, p. 1.
[18] Wheeler Hearing Testimony, TR Vol. I, p. 109, l. 11-p. 113, l. 11.
[19] TR Vol. IX, p. 1847, l. 22-p. 1848, l. 20.
[20] TR Vol. IX, p. 1940, ll. 4-10.
[21] TR Vol. VI, p. 1266, ll. 9-12.
[22] Brandt Direct, APS 4, p. 28, ll. 17-18 and Parcell Direct, Staff 8, p. 19, ll. 6-8.

would strengthen APS's structure as well as its ability to get future financings on more favorable terms. During the hearing on the issue, then-Commissioner Spitzer commented that "the infusion of capital from the unregulated entity into the regulated entity is a positive thing."[23]

As Mr. Brandt discussed, not only was the $450 million equity infusion "positive," it was absolutely critical in keeping the Company away last year from the final step into non-investment grade territory:

> A. At that point in time, the debt to equity ratio and the FFO to debt were so weak—and there's nothing you can do real quick with FFO to debt, but you can adjust the equity ratio. And the agencies told us if we didn't do something about the equity ratio, they were going to take ratings actions.
>
> Q. [By Mr. Grant] Had APS not followed that advice from Moody's and Standard & Poor's and strengthened the debt/equity ratio, in your opinion would a likely result have been a credit downgrade to non-investment grade?
>
> A. At that time...if we had told them we weren't going to issue the equity...we would have been downgraded at least a notch. If we had hit the hurricane season, Hurricane Katrina and Rita and the impact on gas prices, I have no doubt whatsoever we would be junk today. Not a doubt in my mind.[24]

Twice last year, the Commission took important and positive steps to stop APS's precipitous slide into junk bond territory by authorizing an interim adjustor and continuing it until rates take effect in this case. Those supportive actions were well-received, but the risks have not diminished. If anything, S&P's surprising APS downgrade in December 2005, Moody's similar action just days before this Commission approved the interim adjustor in May 2006 and S&P's abrupt junk rating move on Commonwealth Edison just three months ago

[23] Brandt Rebuttal, APS 5, p. 38, ll. 6-13.
[24] TR Vol. II, p. 396, ll. 2-20.

demonstrate the risks have increased.[25] Approval of an 11.5% ROE combined with an attrition allowance of 1.7% are absolutely vital steps to minimize those risks.

CWIP AND INCREASED DEPRECIATION ALLOWANCE

For the same reasons, the Association urges the Commission to approve the Company's requests to (1) place in rate base the Company's actual $261 million generation and distribution construction work in progress ("CWIP") balance as of June 30, 2006 and (2) approve an across-the-board increase of $50 million per year in allowed depreciation expense. Neither of these items increases earnings, but they do provide future customer rate benefits, strengthen the quality of earnings, improve APS's critical FFO/Debt ratio and send an additional, important message to the debt and equity markets that the Commission is interested in balanced steps to improve the Company's financial position.

Although RUCO and Staff have not supported these positions, each of their witnesses has agreed that both have been used by commissions to address attrition in heavy construction periods and that the Company's inability to recover those capital expenditures on a timely basis is having an adverse impact on APS's opportunity to achieve its authorized return.[26] On the latter issue, Dr. Avera explained that the $900 million annual capital expenditure budget which APS is facing now and will continue to face well into the future actually has a worse impact on the Company than the $300 million in annual outlays associated with Palo Verde 20 years ago:

> [T]he fact that they have this growth, the fact that the projects are relatively short-lived, the fact that federal income tax incentives are not present, and the fact that you face regulatory lag, all combine to kind of have deja vu all over again for APS, because it finds itself in the same situation that many, many utilities, including this one, found themselves in in the '70s and '80s.[27]

[25] Brandt Hearing Testimony, TR Vol. II, pp. 415-420.
[26] Hill Hearing Testimony, TR Vol. X, pp. 2135-2139 and Parcell Hearing Testimony, TR Vol. XVII, pp. 3271-3272.
[27] TR Vol. IX, p. 1853, ll. 12-19.

Staff's witness, Mr. Dittmer, also agreed the CWIP and accelerated depreciation allowance would provide reductions in rates for future ratepayers.[28] Additionally, if the Commission approves them, the improvement in the FFO/Debt measure each year would be 1.2%.[29]

Obviously, one of the primary perils APS is facing and will continue to face is the adequacy of cash earnings and their sufficiency on a going-forward basis. Although the FFO/Debt cash metric has improved following the Commission's seven-mill interim adjustor approval, it still remains below the 18% minimum requirement for an investment grade rating. Even assuming that APS's full rate request is granted, it will rise only to 19.2% this year before declining again to 17.5% in 2008.[30] Particularly given the future customer rate benefits which these proposals produce, the CWIP and accelerated depreciation allowances are well-balanced, cost-effective ways to precisely address this primary problem.

POWER SUPPLY ADJUSTOR

In the same category is Staff's "forward looking" Power Supply Adjustor ("PSA") which the AUIA recommends the Commission approve. Of many important issues presented by this case, timely recovery of prudent fuel and purchased power costs is arguably the most important. The Association believes that Staff's PSA proposal is the best way to address it. As with the CWIP and accelerated depreciation proposals, by allowing recovery of costs on the most current basis, it markedly improves cash metrics and offers the best insurance policy against further negative rating agency actions.

---

[28] Staff 37, p. 16, l. 18-p. 17, l. 1.
[29] APS 5, p. 25, l. 8 and p. 27, l. 1.
[30] *Id.,* DEB-1RB, p. 1.

During the hearing, Staff witness John Antonuk discussed several regulatory, economic and financial advantages of the Staff's PSA proposal.[31] Its forward-looking nature better addresses volatile fuel and purchased power costs as well as providing a more current view of those uncertainties than the current system of referencing back to a fuel base tied to a quickly outdated test year. From a regulatory standpoint, the Staff PSA allows both the Commission and the parties a better, more regular focus on this major aspect of APS's cost of doing business and, as Mr. Antonuk put it, "what is driving the changes in the company's costs of serving customers." It uses as its price driver what realistically is expected to be paid in the recovery period rather than relying on historic costs which "bear only a random association with what fuel costs are going to be in the near future."

Finally, Mr. Antonuk noted that Staff's PSA proposal provides the financial community a reasonable level of certainty regarding eventual recovery or refund:

> [O]ur examination of utilities generally in the U.S., and now most recently in Canada, indicates to us that the focus of the rating agencies as it concerns fuel is basically twofold. And these are two related things. They're not different things. One is reasonably current recovery, and two is the ability of the utility to handle volatility in the marketplace. And when you talk about volatility in the marketplace, it's our view that a forward-looking approach is more responsive than a historical approach.[32]

Consistent with that, Ms. Cannell noted that two investment analysts commented favorably on the Staff PSA proposal right after its testimony was filed in late August:

> In the case of Staff's [PSA] recommendations, UBS called them "Constructive suggestions on fuel cost recovery." 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.[33]

[31] TR Vol. XXI, pp. 3886-3890.
[32] TR Vol. XXI, p. 3890, ll. 14-23.
[33] AUIA 2, p. 3, ll. 10-14 (footnotes omitted).

Finally, use of the "forward looking" PSA affords customers the most timely price signal available, allowing them to adjust their usage and consumption patterns accordingly.

Should the Commission elect, however, to continue the current clause structure, AUIA supports several changes to it, including eliminating the total fuel cost cap of $776.2 million, changing the cumulative four-mill cap to an annual limit, elimination of the $100 million deferral trigger for mandatory surcharge applications, as well as eliminating application of the 90/10 sharing arrangement to renewable resources. These changes have broad support from many of the parties to this proceeding.[34] AUIA also strongly urges the Commission to take two additional steps if it orders continuation of the current PSA with modifications: (1) set the base fuel rate at $0.032491/kWh[35] and (2) eliminate the 90/10 cost sharing relationship.

On the first issue, the PSA's recent, most instructive and undoubtedly most painful lesson is the importance of setting the base fuel rate at the correct and most current level. Mr. Robinson discussed the fact that was not done in the last case and the consequences which flowed from it:

> [B]y the time [the PSA] was actually implemented, we were in a situation where that rate was not going to be sufficient to cover the actual fuel costs that we were incurring. That's what led us to having the significant amounts of deferrals and resulted in the necessity of having a surcharge hearing, emergency rate cases, and accelerated implementation of the PSA. So, I'm hoping that we all have learned from that experience to try and avoid doing that again.[36]

As to its currency, clearly the 3.25 cents/kWh which is based on 2007 estimated fuel and purchased power costs is the most timely base available. As to its reliability and accuracy, Mr. Ewen noted:

> [E]ven when the estimates for 2006 were changing in relatively dramatic fashion, the estimates for 2007 remained relatively stable.*** [T]he Company's 2007 fuel

[34] Robinson Rejoinder, APS 9, p. 2, ll. 14-19.
[35] Ewen Rejoinder, APS 18, p. 2, l. 5.
[36] TR Vol. IV, p. 828, ll. 1-9.

> costs are fairly well-known, given the significant degree to which its fuel needs are hedged for 2007.*** I believe the Commission can set the Company's base fuel rate at 3.2491¢/kWh with confidence that the Company's actual fuel costs will correspond closely to that level.[37]

Mr. Antonuk independently confirmed the Company's fuel base reliability. His Liberty Consulting Group conducted an extensive analysis of the forecast's accuracy through five different case assumptions: "[T]his [forecast], we conclude, is comprehensive and logically structured, consistent with reasonable expectations about system assets, and reflective of market price expectations current as of its [September 29, 2006] vintage."[38] In short, Mr. Antonuk testified that Staff and APS agree as to the expected current (2007) year fuel and purchased power cost level.[39]

As importantly, use of the Company's base fuel rate will avoid an unfair and, the AUIA believes, wholly unintended consequence of the 90/10 sharing feature of the current PSA. If the Commission were to order Staff's base fuel rate of 2.7975 cents per kWh, but not adopt the "forward looking" PSA, it virtually guarantees that APS will lose 10% of the 4.5-mill difference—even though both the accuracy of the higher base as well as the prudence of the Company's purchasing/hedging program have been independently confirmed by Staff's consultant.[40] The result would be a $13 million dollar[41] disallowance of prudently incurred fuel and purchased power costs and a $13 million dollar impact on the Company's already beleaguered bottom line. That result would be legally unjustifiable and factually indefensible.

---

[37] Ewen Rejoinder, APS 28, p. 8, ll. 3-17.
[38] Antonuk Supplemental, Staff 30, p. 23, ll. 8-10.
[39] TR, Vol. XXI, p. 3993, ll. 11-23.
[40] Antonuk Hearing Testimony, TR Vol. XXI, p. 3983, l. 19-p. 3984, l. 19.
[41] Ewen Hearing Testimony, TR Vol. XXII, p. 4442, ll. 1-4.

On the second cost-sharing issue, if the Commission retains the current PSA mechanism, it should discontinue the 90/10 APS/customer cost sharing feature as Staff has recommended. In both his pre-filed and hearing testimony, Mr. Antonuk discussed several reasons why the 90/10 sharing arrangement should be eliminated. Summarizing some of his key points:

- The Commission now has the benefit of Liberty's audit, which has "laid out a very detailed baseline of what this company does to manage its fuel costs"[42] and verified those efforts are producing "appropriate costs."[43] That's an assurance the Commission did not have two years ago when it adopted the sharing arrangement.
- The 90/10 sharing arrangement fails to focus on the actual drivers of fuel and purchased power costs. Instead, it treats all costs as controllable and, as Mr. Antonuk noted, "A lot of what any company pays can't really be changed that much."[44]
- Because APS growth has to be met by high-cost resources on the margin, APS fuel costs will continue to increase even if fuel prices stabilize, making fuel side growth a negative for APS.[45]
- As a result, Mr. Antonuk pointed out that the 90/10 sharing arrangement is almost always a punishment and never a reward because "they have to fund a lot of new growth through their most expensive sources of power."[46]

---

[42] TR Vol. XXI, p. 3895, ll. 1-3.
[43] Antonuk Direct, Staff 29, p. 4, ll. 1-3.
[44] TR Vol. XXI, p. 3897, ll. 22-24.
[45] *Id.*, p. 3989, ll. 2-18.
[46] *Id.*, p. 3896, ll. 17-18.

Given these deficiencies, the Staff witness offered this view as to why 90/10 sharing is harming customers:

> I see regulation in the utility industry as doing the best job it can to model how the economy operates. And the way the economy operates is that it rewards efficiency and penalizes inefficiency. If all the economy did was penalize inefficiency, I don't think we would have much of an economy. So I just don't really see a one-sided effort as promoting positive performance for customers.[47]

In summary, the AUIA recommends approval of Staff's "forward looking" PSA. Should the Commission instead elect to continue the current PSA structure, the Association recommends the refinements stated previously, adoption of a fuel base rate of $0.032491/kWh and elimination of its 90/10 cost sharing feature.

OTHER ISSUES

Palo Verde

Staff has recommended disallowance of approximately $17.4 million in additional costs incurred as a result of certain unplanned outages at the Palo Verde Plant in 2005.[48] The vast majority of the recommended disallowance pertains to the Unit 2 and 3 reactor water tank ("RWT") or "new question" outage which occurred from October 11-20, 2005. For several reasons, the Commission should not disallow these costs.

First, as an overall matter, Staff consultant Dr. Jacobs' recommendation fails to take into account corrections and offsets which exceed the recommended level of disallowed costs. Dr. Jacobs overstated the net replacement power costs associated with the 2005 outages and also failed to take into account the offsetting superior power performance of the Company's coal plants—the benefits of which have already been passed through to customers by the PSA.[49] The

---

[47] *Id.*, p. 3999, l. 19-p. 4000, l. 1.
[48] Jacobs Direct, Staff 47, p. 3.
[49] Ewen Rebuttal, APS 17, pp. 19-25.

five corrections to the recommended disallowance as well as the coal plant performance offset total $18.6 million. Thus, even assuming for the sake of argument that the outages were imprudent, properly adjusted, the corrections and offsets exceed the recommended disallowed amount by more than $1 million.

Second, as to the RWT disallowance, Dr. Jacobs' recommendation requires the Commission to reject both the conclusion of the NRC official who was in charge of overseeing the design phase of Palo Verde 30 years ago as well as the statements of the current NRC Region IV Administrator before this Commission in January 2006 that the outage was <u>not</u> imprudent because it related to a "new question"—one which could not have been foreseen by Palo Verde personnel. Dr. Mattson was in charge of the NRC headquarters staff in the 1970s when this same question was actively raised and satisfactorily addressed in the design phase of Palo Verde. He testified:

> A. The question is new in my judgment and shouldn't have been anticipated for a couple of reasons. One, because it's as a matter of engineering it's new. That question, to my knowledge, has never been asked of any nuclear power plant in the United States of America, the dynamic calculation for flow in that line. It's also new because it's not a question that had a nexus to the yellow violation. Remember, the yellow violation went to, have you <u>implemented</u> your design properly?... This [October 2006] question went to the <u>adequacy</u> of the design.
>
> * * *
>
> Q. [By Mr. Grant] And Dr. Mallett, the NRC regional administrator, also acknowledged that it was a new question, correct?

A. Yes, he did. He was asked a direct question here in his appearance before this Commission as to whether the Company should have anticipated it. He said they should not have.[50] (Emphasis supplied.)

Finally, even if APS personnel had been clairvoyant enough while preparing for the inspection to discern that the NRC inspector would ask a three-decades-old design adequacy question, Dr. Mattson also testified that the outage still would have occurred. It just would have occurred in the summer instead of October, 2005.[51] In other words, Staff witness Dr. Jacobs maintains APS personnel would have been prudent if they had asked the question prior to the NRC inspection. Had they done so in July 2005, NRC procedures would have required precisely the same shutdown with the same (or greater, given the summer peak) attendant replacement power costs because there was no ready answer to the design question.

All of the witnesses agree that APS's actions and decisions have to be judged based on what they knew or reasonably should have known without benefit of hindsight. This record simply does not support a finding of imprudence.

<u>Environmental Improvement Charge</u>

Given the Company's enormous capital needs for the foreseeable future and the impacts those are having and will continue to have on APS's earnings, attractiveness to the debt and equity markets and its credit ratings, AUIA also urges the Commission to adopt the Environmental Improvement Charge ("EIC") discussed in Messrs. Fox and DeLizio's testimony. It's clear that the Company's fleet of fossil fuel plants provide very cost-efficient power. As Mr. Ewen noted:

---

[50] TR Vol. XXVI, p. 4921, l. 2-p. 4923, l. 17.
[51] *Id.*, p. 5027, l. 5-p. 5029, l. 6.

> The Company's coal plants had a remarkable year of performance in 2005 and set an all-time high for capacity factor, which means they produced more power in 2005 than in any previous year. These plants had 40% less unplanned outage time than the normalized amount...and this "better than normal" performance reduced fuel costs by $10.0 million... The variable fuel costs for the coal plants are almost as low as those for Palo Verde... Customers have already received the benefit of these fuel expense savings through the PSA mechanism.[52]

But, it's equally clear that environmental improvements to these plants (as well as other kinds of necessary environmental improvements) will also require considerable capital investments. Those amounts will add to the already considerable pressure on APS's financial performance. Finally, they represent a sound investment in Arizona's environmental future, which also faces increasing challenges given the State's extraordinary growth.

The EIC affords the Commission an opportunity to "get ahead" of this issue and mitigate the impact which these non-revenue producing improvements will have on the Company's earnings and its $900 million annual capital expenditure requirements. As proposed, the EIC contains a true-up mechanism to assure that only actual costs will be recovered. The Association recommends its approval.

CONCLUSION

From 1995 to 2005, the Company decreased rates by some $1.74 billion, while simultaneously investing $2 billion in new transmission and distribution infrastructure and increasing employee productivity by 32%.[53] As impressive as those numbers are, for the foreseeable future, APS debt and equity needs will total almost $1 billion annually and projected capital expenditures for each new customer exceed by almost $11,000 the amount reflected in current rates.[54] The Company not only needs assured access to the capital markets to meet the

[52] Ewen Direct, APS 17, p. 25, ll. 5-16.
[53] Wheeler Direct, APS 1, p. 3, ll. 15-16; p. 17, ll. 6-9; and p. 16., ll. 11-13.
[54] APS Exhibits 27 and 59.

challenges of Arizona's rapid growth, it needs that access on fair and reasonable terms. Given the Company's perch on the precipice of junk bond status, its ability to gain that access is very much in doubt.

The Commission has the opportunity to stabilize APS's financial position and assure that our collective fate will not be left to, among other things, weather patterns in the Atlantic and Gulf, political developments in the Mid-East and perceptions of regulatory climate by rating agencies and investment analysts. An adequate level of non-fuel revenue requirements combined with an 11.5% ROE, an additional 1.7% ROE attrition adjustment, CWIP and accelerated depreciation allowances and approval of Staff's "forward looking" PSA are well-balanced responses to assure that the Company can continue to provide safe, reliable and adequate service at just and reasonable rates.

RESPECTFULLY SUBMITTED this 22nd day of January, 2007.

GALLAGHER & KENNEDY, P.A.

By Michael M. Grant

Michael M. Grant
2575 East Camelback Road
Phoenix, Arizona 85016-9225
Attorneys for Arizona Utility Investors Association

Original and seventeen copies filed this 22nd day of January, 2007, with:

Docket Control
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Copies of the foregoing delivered this
22nd day of January, 2007, to:

Commissioner Jeff Hatch-Miller, Chairman
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Commissioner William A. Mundell
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Commissioner Mike Gleason
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Commissioner Kristin K. Mayes
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Commissioner Gary Pierce
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Lyn A. Farmer
Chief Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington
Phoenix, Arizona 85007

Christopher Kempley
Chief Counsel, Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Ernest G. Johnson
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Janice Alward
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Gordon Fox
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Copies of the foregoing mailed this 22nd day of January, 2007, to:

Thomas L. Mumaw
Pinnacle West Capital Corporation
Post Office Box 53999, MS 8695
Phoenix, Arizona 85072-3999

Scott Wakefield
Residential Utility Consumer Office
1110 West Washington Street, Suite 220
Phoenix, Arizona 85007

Deborah R. Scott
Kimberly A. Grouse
Snell & Wilmer
One Arizona Center
400 East Van Buren
Phoenix, Arizona 85004-2202

Bill Murphy
Murphy Consulting
5401 North 25th Street
Phoenix, Arizona 85016

Douglas V. Fant
Law Offices of Douglas V. Fant
PMB 411
3655 West Anthem Drive, Suite A109
Anthem, Arizona 85086

Dan Austin
Comverge, Inc.
6509 West Frye Road, Suite 4
Chandler, Arizona 85226

Michael Patten
Roshka DeWulf & Patten, P.L.C.
One Arizona Center
400 East Van Buren, Suite 800
Phoenix, Arizona 85004

Jim Nelson
12621 North 17th Place
Phoenix, Arizona 85022

Michelle Livengood
UniSource Energy Services
One South Church Street, Suite 200
Tucson, Arizona 85702

Timothy Hogan
Arizona Center for Law in Public Interest
202 East McDowell Road, Suite 153
Phoenix, Arizona 85004

Tracy Spoon
Sun City Taxpayers Association
12630 North 103rd Avenue, Suite 144
Sun City, Arizona 85351

George Bien-Willner
3641 North 39th Avenue
Phoenix, Arizona 85014

Gary Yaquinto
Arizona Utility Investors Association
2100 North Central Avenue, Suite 210
Phoenix, Arizona 85004

Michael L. Kurtz
Kurt J. Boehm
Boehm, Jurtz & Lowry
36 East Seventh Street, Suite 1510
Cincinnati, Ohio 45202
Attorneys for The Kroger Co.

C. Webb Crockett
Patrick J. Black
Fennemore Craig
3003 North Central Avenue, Suite 2600
Phoenix, Arizona 85012-2913
Attorneys for Phelps Dodge Mining Company and
Arizonans for Electric Choice and Competition

Steven B. Bennett
Deputy City Attorney
City of Scottsdale
3939 North Drinkwater Boulevard
Scottsdale, Arizona 85251

Robert W. Geake
Arizona Water Company
Post Office Box 29006
Phoenix, Arizona 85038

Lieutenant Colonel Karen S. White
Chief, Air Force Utility Litigation Team
AFLSA/JACL-ULT
139 Barnes Drive
Tyndall AFB, Florida 32403

Greg Patterson
916 West Adams, Suite 3
Phoenix, Arizona 85007

Lawrence V. Robertson, Jr.
Munger Chadwick, P.L.C.
Post Office Box 1448
Tubac, Arizona 85646-0001
Attorneys for Mesquite Power, L.L.C.,
Southwestern Power Group, II, L.L.C.
and Bowie Power Station, L.L.C.

Andrew W. Bettwy
Southwest Gas Corporation
5241 West Spring Mountain Road
Las Vegas, Nevada 98150

Jay I. Moyes
Moyes Storey
1850 North Central Avenue, Suite 1100
Phoenix, Arizona 85004

Kenneth Saline
160 North Pasadena, Suite 101
Mesa, Arizona 85201

Sean Seitz
3008 North Civic Center Plaza
Scottsdale, Arizona 85251

Amanda Ormond
7650 South McClintock, Suite 103-282
Tempe, Arizona 85284

David Kennedy
818 East Osborn Road, Suite 103
Phoenix, Arizona 85014-0000

18762-3/1499005