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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.

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**Initial Brief
on Behalf of
Arizona Utility Investors Association
January 22, 2007**

Arizona Corporation Commission
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1 The Arizona Utility Investors Association (“AUIA” or the “Association”) submits this
2 Initial Brief in relation to Arizona Public Service Company’s (“APS” or the “Company”)
3 application for a rate increase.

4 INTRODUCTION

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

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

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

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

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

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

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21
22 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.

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

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

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

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

22 ⁶ AUIA 1, p. 18, ll. 19-21.

23 ⁷ Brandt Hearing Testimony, TR Vol. IV, p. 719.

24 ⁸ Brandt Direct, APS 4, p. 4, ll. 9-23.

⁹ AUIA 1, p. 6, ll. 2-4.

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

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

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

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

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

12 RETURN ON EQUITY

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

16 Considering investors' expectations for capital markets, the substantial funding
17 requirements faced by APS, and the need to support financial integrity and fund
18 crucial capital investment even under adverse circumstances, it is my opinion that
11.5% is a reasonable ROE for APS.¹¹

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

23 ¹⁰ Chairman's July 21, 2006 letter to this Docket.

24 ¹¹ Avera Direct, APS 41, p. 3, l. 24-p. 4, l. 2.

1 Capital Market Expectations: “I think capital market expectations is both a
2 macro, a large issue of what investors expect in the future, for example, the
3 general expectation of rising long-term interest rates. This morning [October 24,
4 2006] we hit a five-week high in long-term interest rates.*** And then I think
5 there’s also market expectations as they apply directly to APS, which includes, for
6 example, the circumstances that APS faces of enduring attrition, having a
7 significant capital budget, operating in a regulatory environment that has recently
8 been constructive but still generally takes a long time to react.”

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

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

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

30 Ms. Cannell presented an extensive review of investor expectations which support the
31 11.5% ROE award noting, among other things, that Lehman Brothers’ projections for industry

32 ¹² Avera Hearing Testimony, TR Vol. IX, p. 1859, l. 10-p. 1864, l. 1.

33 ¹³ Brandt Hearing Testimony, TR Vol. II, p. 398, ll. 8-10.

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

3 [I]nvestors expect the final ROE award to be at the high end of that range [11.5%]
4 given the facts, among others, that: (1) [APS's] financial position is weak; (2) the
5 Company remains just one step above a non-investment grade rating; (3) the
6 utility sector generally is viewed as more risky today than historically; and
7 (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

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

16 The [ROE] recommendations [of ACC Staff and RUCO] mark the likely worst
17 case in this proceeding. We view fair treatment by the ACC as essential to APS'
18 investment grade rating and attraction to equity investors. Should the final order
19 reflect financial parameters approximating these filings, it would be difficult for
20 Arizona Public Service...to maintain investment grade ratings or provide support
21 for the current stock value in our view. While Arizona has historically been a
22 very difficult jurisdiction for investors, we look for a final ACC order in 2Q of
23 2007 to significantly improve upon Friday's [Staff and RUCO] filings.
(Emphasis supplied.)¹⁶

24

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.

1 In addition to the 11.5% ROE, an equally important measure to help APS gradually
2 improve its creditworthiness is a 1.7% attrition allowance to afford the Company some
3 opportunity to actually earn its authorized rate of return. Both historic achieved returns and
4 projections leave no doubt that APS will not have that opportunity absent an attrition allowance.
5 For example, less than 15 months after the Commission authorized a 10.25% ROE, APS's actual
6 return on capital was only 5.7% as of June 30, 2006.¹⁷ The Commission has previously
7 authorized a much larger explicit attrition adjustment, when APS's capital requirements were
8 less than they are today and its creditworthiness was considerably stronger.¹⁸

9 Dr. Avera testified that a 1.7% allowance is very conservative in light of APS's 2003-
10 2006 actual earnings experience of 200-400 basis points and more below the authorized return¹⁹
11 and, in response to a question from Commissioner Gleason, discussed its "market" value as well:

12 [T]he fact that APS is BBB-minus and that the rating agencies in their writings
13 have explicitly said they're concerned about attrition, I think that makes it
14 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

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

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

21 ¹⁷ Brandt Rebuttal, APS 5, DEB-9RB, p. 1.

¹⁸ Wheeler Hearing Testimony, TR Vol. I, p. 109, l. 11-p. 113, l. 11.

22 ¹⁹ TR Vol. IX, p. 1847, l. 22-p. 1848, l. 20.

²⁰ TR Vol. IX, p. 1940, ll. 4-10.

23 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.

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

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

7 A. At that point in time, the debt to equity ratio and the FFO to debt were so
8 weak—and there's nothing you can do real quick with FFO to debt, but
9 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.

10 Q. [By Mr. Grant] Had APS not followed that advice from Moody's and
11 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?

12 A. At that time...if we had told them we weren't going to issue the equity...we
13 would have been downgraded at least a notch. If we had hit the hurricane
14 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

15 Twice last year, the Commission took important and positive steps to stop APS's
16 precipitous slide into junk bond territory by authorizing an interim adjustor and continuing it
17 until rates take effect in this case. Those supportive actions were well-received, but the risks
18 have not diminished. If anything, S&P's surprising APS downgrade in December 2005,
19 Moody's similar action just days before this Commission approved the interim adjustor in May
20 2006 and S&P's abrupt junk rating move on Commonwealth Edison just three months ago

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22

23 ²³ Brandt Rebuttal, APS 5, p. 38, ll. 6-13.

24 ²⁴ TR Vol. II, p. 396, ll. 2-20.

24

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

3 CWIP AND INCREASED DEPRECIATION ALLOWANCE

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

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

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

24 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.

1 Staff's witness, Mr. Dittmer, also agreed the CWIP and accelerated depreciation
2 allowance would provide reductions in rates for future ratepayers.²⁸ Additionally, if the
3 Commission approves them, the improvement in the FFO/Debt measure each year would be
4 1.2%.²⁹

5 Obviously, one of the primary perils APS is facing and will continue to face is the
6 adequacy of cash earnings and their sufficiency on a going-forward basis. Although the
7 FFO/Debt cash metric has improved following the Commission's seven-mill interim adjustor
8 approval, it still remains below the 18% minimum requirement for an investment grade rating.
9 Even assuming that APS's full rate request is granted, it will rise only to 19.2% this year before
10 declining again to 17.5% in 2008.³⁰ Particularly given the future customer rate benefits which
11 these proposals produce, the CWIP and accelerated depreciation allowances are well-balanced,
12 cost-effective ways to precisely address this primary problem.

13 POWER SUPPLY ADJUSTOR

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

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23 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.

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

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

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

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

22 In the case of Staff's [PSA] recommendations, UBS called them "Constructive
23 suggestions on fuel cost recovery." Bank of America expressed similar views:
24 "[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).

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

3 Should the Commission elect, however, to continue the current clause structure, AUIA
4 supports several changes to it, including eliminating the total fuel cost cap of \$776.2 million,
5 changing the cumulative four-mill cap to an annual limit, elimination of the \$100 million deferral
6 trigger for mandatory surcharge applications, as well as eliminating application of the 90/10
7 sharing arrangement to renewable resources. These changes have broad support from many of
8 the parties to this proceeding.³⁴ AUIA also strongly urges the Commission to take two additional
9 steps if it orders continuation of the current PSA with modifications: (1) set the base fuel rate at
10 \$0.032491/kWh³⁵ and (2) eliminate the 90/10 cost sharing relationship.

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

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

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

23 [E]ven when the estimates for 2006 were changing in relatively dramatic fashion,
24 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.

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

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

12 As importantly, use of the Company's base fuel rate will avoid an unfair and, the AUIA
13 believes, wholly unintended consequence of the 90/10 sharing feature of the current PSA. If the
14 Commission were to order Staff's base fuel rate of 2.7975 cents per kWh, but not adopt the
15 "forward looking" PSA, it virtually guarantees that APS will lose 10% of the 4.5-mill
16 difference—even though both the accuracy of the higher base as well as the prudence of the
17 Company's purchasing/hedging program have been independently confirmed by Staff's
18 consultant.⁴⁰ The result would be a \$13 million dollar⁴¹ disallowance of prudently incurred fuel
19 and purchased power costs and a \$13 million dollar impact on the Company's already
20 beleaguered bottom line. That result would be legally unjustifiable and factually indefensible.

21 _____
³⁷ Ewen Rejoinder, APS 28, p. 8, ll. 3-17..

22 ³⁸ Antonuk Supplemental, Staff 30, p. 23, ll. 8-10.

23 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.

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

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

22 ⁴² TR Vol. XXI, p. 3895, ll. 1-3.

23 ⁴³ Antonuk Direct, Staff 29, p. 4, ll. 1-3.

24 ⁴⁴ TR Vol. XXI, p. 3897, ll. 22-24.

⁴⁵ *Id.*, p. 3989, ll. 2-18.

⁴⁶ *Id.*, p. 3896, ll. 17-18.

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

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

13 A. The question is new in my judgment and shouldn't have been anticipated
14 for a couple of reasons. One, because it's as a matter of engineering it's
15 new. That question, to my knowledge, has never been asked of any
16 nuclear power plant in the United States of America, the dynamic
17 calculation for flow in that line. It's also new because it's not a question
18 that had a nexus to the yellow violation. Remember, the yellow violation
19 went to, have you implemented your design properly?... This [October
20 2006] question went to the adequacy of the design.

21 * * *

22 Q. [By Mr. Grant] And Dr. Mallett, the NRC regional administrator, also
23 acknowledged that it was a new question, correct?

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

4 Finally, even if APS personnel had been clairvoyant enough while preparing for the
5 inspection to discern that the NRC inspector would ask a three-decades-old design adequacy
6 question, Dr. Mattson also testified that the outage still would have occurred. It just would have
7 occurred in the summer instead of October, 2005.⁵¹ In other words, Staff witness Dr. Jacobs
8 maintains APS personnel would have been prudent if they had asked the question prior to the
9 NRC inspection. Had they done so in July 2005, NRC procedures would have required precisely
10 the same shutdown with the same (or greater, given the summer peak) attendant replacement
11 power costs because there was no ready answer to the design question.

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

15 Environmental Improvement Charge

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

22

23 ⁵⁰ TR Vol. XXVI, p. 4921, l. 2-p. 4923, l. 17.

⁵¹ *Id.*, p. 5027, l. 5-p. 5029, l. 6.

24

1 The Company's coal plants had a remarkable year of performance in 2005 and set
2 an all-time high for capacity factor, which means they produced more power in
3 2005 than in any previous year. These plants had 40% less unplanned outage
4 time than the normalized amount...and this "better than normal" performance
5 reduced fuel costs by \$10.0 million... The variable fuel costs for the coal plants
6 are almost as low as those for Palo Verde... Customers have already received the
7 benefit of these fuel expense savings through the PSA mechanism.⁵²

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

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

18 CONCLUSION

19 From 1995 to 2005, the Company decreased rates by some \$1.74 billion, while
20 simultaneously investing \$2 billion in new transmission and distribution infrastructure and
21 increasing employee productivity by 32%.⁵³ As impressive as those numbers are, for the
22 foreseeable future, APS debt and equity needs will total almost \$1 billion annually and projected
23 capital expenditures for each new customer exceed by almost \$11,000 the amount reflected in
24 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.

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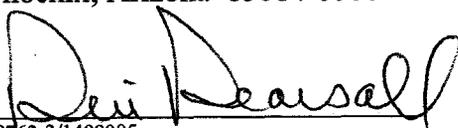
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