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APS ORIGINAL

Barbara Klemstine
Director
Regulation & Pricing

Tel. 602-250-4563
Fax 602-250-3003
e-mail Barbara.Klemstine@aps.com

Mail Station 9708
PO Box 53999
Phoenix, Arizona 85072-3999

September 8, 2008

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

Re: ARIZONA PUBLIC SERVICE COMPANY – INTERIM RATE CASE
DOCKET NO. E-01345A-08-0172

Dear Sir or Madam:

Pursuant to Procedural Order filed July 16, 2008, by Chief Administrative Law Judge Lyn Farmer please find Arizona Public Service Company's (APS') Rebuttal Testimony for witnesses William J. Post, Donald E. Brandt, Charles J. Cicchetti, and David J. Rumolo pertaining to APS' request for an interim rate increase.

If you have any questions regarding this filing, please contact me at (602) 250-4563.

Sincerely,

Barbara A. Klemstine

Barbara A. Klemstine

BAK/dst

Attachment

CC: Terri Ford
Maureen Scott
Lyn Farmer
Parties of Record

Copies of the foregoing emailed or mailed
This 8th day of September 2008 to:

Ernest G. Johnson
Director, Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
ejohnson@cc.state.az.us

Maureen Scott
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
mscott@azcc.gov

Janet Wagner
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
jwagner@azcc.gov

Terri Ford
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
tford@azcc.gov

Barbara Keene
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85007
bKeene@cc.state.az.us

Daniel Pozefsky
Chief Counsel
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007
dpozefsky@azruco.com

William A. Rigsby
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007
brigsby@azruco.gov

Tina Gamble
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007
egamble@azruco.gov

C. Webb Crockett
Fennemore Craig
3003 North Central, Suite 2600
Phoenix, AZ 85012-2913
wcrocket@fclaw.com

Kevin Higgins
Energy Strategies, LLC
215 South State Street, Suite 200
Salt Lake City, UT 84111
khiggins@energystrat.com

Michael L. Kurtz
Boehm, Kurt & Lowry
36 East Seventh Street, Suite 2110
Cincinnati, OH 45202
mkurtz@BKLlawfirm.com

Kurt J. Boehm
Boehm, Kurt & Lowry
36 East Seventh Street, Suite 2110
Cincinnati, OH 45202
kboehm@BKLlawfirm.com

The Kroger Company
Dennis George
Attn: Corporate Energy Manager (G09)
1014 Vine Street
Cincinnati, OH 45202
dgeorge@kroger.com

Stephen J. Baron
J. Kennedy & Associates
570 Colonial Park Drive
Suite 305
Roswell, GA 30075
sbaron@jkenn.com

Theodore Roberts
Sempra Energy Law Department
101 Ash Street, H Q 13D
San Diego, CA 92101-3017
TRoberts@sempra.com

Lawrence V. Robertson, Jr.
2247 E. Frontage Road
Tubac, AZ 85646
tubaclawyer@aol.com

Michael A. Curtis
501 East Thomas Road
Phoenix, AZ 85012
mcurtis401@aol.com

William P. Sullivan
501 East Thomas Road
Phoenix, AZ 85012
wsullivan@cgsuslaw.com

Larry K. Udall
501 East Thomas Road
Phoenix, AZ 85012
ludall@cgsuslaw.com

Michael Grant
Gallagher & Kennedy, P.A.
2575 East Camelback Road
Phoenix, AZ 85016
MMG@gknet.com

Gary Yaquinto
Arizona Investment Council
2100 North Central, Suite 210
Phoenix, AZ 85004
gyaquinto@arizonaic.org

David Berry
Western Resource Advocates
P.O. Box 1064
Scottsdale, AZ 85252-1064
azbluhill@aol.com

Tim Hogan
Arizona Center for Law in the Public Interest
202 East McDowell Road
Suite 153
Phoenix, AZ 85004
thogan@aclpi.org

Jeff Schlegel
SWEEP Arizona Representative
1167 W. Samalayuca Dr.
Tucson, AZ 85704-3224
schlegelj@aol.com

Jay I. Moyes
MOYES, SELLERS, & SIMS
1850 North Central Avenue, Suite 1100
Phoenix, AZ 85004
jimoyes@lawms.com

Karen Nally
MOYES, SELLERS, & SIMS
1850 North Central Avenue, Suite 1100
Phoenix, AZ 85004
kenally@lawms.com

Jeffrey J. Woner
K.R. Saline & Assoc., PLC
160 N. Pasadena, Suite 101
Mesa, AZ 85201
jjw@krsaline.com

Scott Canty
General Counsel the Hopi Tribe
P.O. Box 123
Kykotsmovi, AZ 86039
Scanty0856@aol.com

REBUTTAL TESTIMONY OF WILLIAM J. POST

On Behalf of Arizona Public Service Company

Docket No. E-01345A-08-0172

(Interim Rate Request)

September 8, 2008

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REBUTTAL TESTIMONY OF WILLIAM F. POST
ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY
(Docket No. E-01345A-08-0172)
(Interim Rate Request)

I. <u>INTRODUCTION</u>

Q. PLEASE STATE YOUR NAME AND ADDRESS.

A. My name is William J. Post. My business address is 400 N. 5th Street, Phoenix, Arizona, 85004.

Q. WHAT IS YOUR POSITION WITH ARIZONA PUBLIC SERVICE COMPANY ("APS" OR "COMPANY")?

A. I am Chairman of the Board for APS. I am also Chairman and CEO of Pinnacle West Capital Corporation ("Pinnacle West").

Q. DID YOU PREVIOUSLY FILE TESTIMONY IN THIS MATTER?

A. No.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY IN THIS PROCEEDING?

A. I will explain why it is critical both for the Company and for our customers that APS receive interim rate relief in this proceeding. In that regard, I take strong exception to the conclusions of Staff consultants Ralph Smith and David Parcell, as well as those of Stephen Ahearn of the Residential Utility Consumer Office ("RUCO").

II. <u>SUMMARY</u>

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. What the Commission must decide in this case is not just the definition or application of a word ("emergency"). Neither must it find that APS rests perilously on the edge of an immediate financial disaster in order to conclude that interim rate relief is in the public interest. Rather, this proceeding provides the opportunity to continue to move APS and our combined public-private decision model with the Arizona Corporation Commission ("Commission") to the level required to meet the state's energy future. Effective decisions concerning energy policy are made today across the country through the cooperative efforts of state regulatory agencies and utilities. Evidence the activities of Florida, North Carolina, Georgia and California to establish energy policy and create the necessary structure to achieve the associated energy policy goals.

In this regard, the Commission has made significant progress with APS to modify and in some cases establish new methods toward the establishment of such a public-private decision model. The re-regulation of APS as a vertically integrated utility, the approval and implementation of a comprehensive power supply adjustment clause as well as a mechanism for a more timely recovery of transmission costs, the development of a new resource planning structure, the approval of a renewable resource portfolio standard and a deepened commitment to DSM, and most recently adoption of a new line extension process, have all been developed over the last 3 years. Collectively, these changes have modified the historic regulatory structure to develop a more contemporary decision model that incorporates the realities of today's energy challenges.

Two important steps remain. First, the creation of a structure to reduce the substantial regulatory lag in Arizona and second, the method to approve and acquire new base load energy resources. This hearing deals directly with the first step and will be dispositive of Arizona's options for the second step.

APS requested interim rate relief to reverse the clear and undeniable decline in the Company's financial strength – a decline that threatens the Commission and APS's ability to usher in the sustainable energy future that is within our grasp. I hope and believe that the Commission will share our goals and will take this opportunity to send a message to the utility industry, rating agencies and the financial markets that this Commission understands the need of a financially stronger APS to provide for future customers in a timely and fiscally responsible manner.

APS CEO Donald Brandt has presented the financial arguments for interim relief, describing both the source of and the solution to the Company's ongoing financial decline. He has also described the potential disaster to APS customers that would accompany the failure to arrest that decline through the grant of interim rate relief. I will not repeat his arguments. Instead, I describe why I believe it is critical for this Commission to grant interim relief and, by doing so, to continue to build on the track record of steady improvements to this state's regulatory model that have been implemented over the past three years.

III. WHY APS NEEDS INTERIM RATE RELIEF

Q. WHY DOES APS NEED INTERIM RELIEF AND WHY DOES IT NEED IT NOW?

A. A positive interim rate decision is vital for six reasons. Each one individually provides a stand-alone basis for approval of this request; collectively they show the positive opportunity we have to move our State forward with a leading regulatory structure, one that will allow Arizona to continue to determine its own energy future.

A. Regulatory Lag

Regulatory lag should never be accepted as "normal." And in any form, it is not beneficial to our customers, our investors, or our State. Moreover, there is nothing "normal" about setting rates today based on a rate base and cost of service that in many instances are as much as three years old unless one were to assume that rate base and cost of service had remained unchanged over time. Although I realize our State has a strong constitutional foundation to pricing electric and other regulated services, it also provides this Commission the authority to modify the process to meet changing conditions.

For example, in 1999, after several years of discussions, hearings and legislative and regulatory decisions, our State decided de-regulation of generation and other services was an appropriate goal and established a process to completely disassemble an 87-year history of vertical integration and regulation of electric utilities. Although this Commission subsequently reversed most aspects of de-regulation and has placed other aspects of retail electric competition on hold pending further study, this and other experiences show that it is possible to modify and improve the regulatory model in our state.

Don Brandt describes the negative financial impacts of regulatory lag. I would add that regulatory lag also fails to provide the appropriate price signal to our customers, which affects both short and long-term decisions concerning energy consumption and resources. This is particularly harmful to customers when APS, with this Commission's strong support, is making and will continue to make such a substantial commitment to energy efficiency and conservation programs. Incorrect or even delayed price signals only serve to frustrate these goals. The regulatory lag experienced by APS also inherently reinforces the inaccurate impression that APS is only interested in increasing prices and that the Commission is only concerned with delaying price increases. This appearance of an over-emphasis on process versus a full factual and policy examination of all rationales for a given price level leads outsiders to incorrect conclusions about the intent of the Commission. Processes are important, and they provide this Commission with a sound basis for decision-making; however, they should never substitute for nor limit the Commission's authority to apply its own sound judgment to changing conditions.

B. Consistent Objective and Goals

Analyst reports and rating agency releases have incorrectly and unfairly left some with the impression that this Commission is anti-APS or hostile to investment. I have never believed this picture was an accurate portrayal of what was going on in Arizona, particularly with respect to APS. I am confident that the objectives of our Company and those of the Commission are fundamentally consistent with each other. One of the important and fundamental process tools for decision-making is the fact-finding hearing process. Unfortunately, the sometimes-adversarial nature of this process leads some to believe we have divergent objectives for customer growth, customer service, reliability, fuel diversity, financial strength and economic development for our state. By granting interim rate relief in this case, we have the extraordinary opportunity not only to improve the capital market's understanding of our unity of purpose in attracting capital for new infrastructure at the lowest possible cost but to impress on the market, and indeed the entire industry, our combined commitment to a healthy APS and sustainable energy future for our state.

Even more than in the past, the combined efforts of our Company and the Commission are needed to efficiently maintain future energy independence for our state. In the past, the Commission has assumed leadership roles in helping to expand Arizona's coal-fired generation and add nuclear power to the mix during the late 1970s and 1980s by providing consistent regulatory support in the form of CWIP, attrition allowances, regulatory accounting orders and also interim rates. In the 1990s, this Commission adopted a unit cost pricing model that reinforced the important aspects of cost efficiency and productivity. Later, the Commission halted the move toward restructuring in time to prevent a California-like debacle in Arizona, with APS acquiring the critically needed new generation that had been built by Pinnacle West Energy. And more recently, this Commission has approved and implemented effective rate adjustment mechanisms for fuel and purchased power and critically needed transmission infrastructure. It then moved to address escalating costs of distribution by approving a new and innovative approach to new or expanding electric service extensions via the changes to APS Service Schedule 3.

This is a significant record of accomplishment, and one that I believe is not fully appreciated by those who influence the capital markets due in part to an overemphasis on the contentious discussions in our sometimes adversarial hearing process. Now, it is time for both of us to step up and take leadership in establishing a comprehensive vision for Arizona's future. That vision should include significant additional investments in new infrastructure, new technology, energy efficiency, and new more sustainable resources. It should also be focused on maintaining energy independence for APS and Arizona. The tools required include a financially strong APS rather than a utility that continuously bumps along the bottom of the investment grade world suffering from chronic and severe earnings shortfalls. We have established an internal goal of achieving 100% internal cash generation of our capital requirements by 2011, however this goal will be unachievable by 2011 or any other date without Commission support for the recovery of our costs.

If it seems like I sound like a broken record on the theme of new investment, that is entirely intentional. We cannot hope to achieve any of our mutual goals without the need for new investment in Arizona infrastructure. In addition, that new investment will not be possible unless APS regains a solid investment grade rating (BBB or higher), can earn its cost of equity capital on a regular basis and can approach and eventually reach energy and financial self-sufficiency. We will never be successful if we settle for a financial goal that keeps APS on the perilous edge of downgrade and mired in massive deficit financing as Mr. Brandt describes in his Affidavit on pages 7-9.

C. Financial Strength

APS and indeed our state needs to have the ability to pursue all available generating resource options. This requires both the time to implement as well as the ability to finance the right alternative. Although today we do not see the need for new base load generation until later into the next decade, the lead-time for completion of these projects makes the decision for them timely. The time to evaluate and consider future resource options is now even if new base load generation will not be needed to serve load for several years. APS will not be able to realistically consider capital-intensive resource options (whether built by APS or by others and contracted to APS) such as nuclear, large-scale solar projects such as Solana, or even new clean coal technology with a marginally investment-grade status that is under constant pressure from growth and cost increases combined with excessive regulatory lag. This very real possibility that APS and this Commission will be prevented from considering what may be superior energy options for Arizona is an energy crisis no less real than those that faced Arizona in the 1970s and 80s, and most recently in the early years of this decade.

When APS was last granted non-fuel interim base rate relief, it was 1984 and the concern then expressed by the Commission was that APS might fall from BBB+ to BBB, which in turn would jeopardize its ability to finance Palo Verde. How far have we fallen to now set our sights, as have Staff's consultants and the Intervenor witnesses, on the bottom reaches of BBB-, when the challenges facing APS, its customers, and this state are at least as great as those faced in the 1970s and 80s?

In 1999, after five years of workshops, hearings, legislative efforts and regulatory decisions, the Commission finally approved an electric restructuring plan for APS in the form of a 1999 Settlement Agreement. That plan determined that APS would no longer be permitted to build or own generation after 2002. During that same period, our electric reserve margins dropped from 15% to 5%. More importantly, the only option we had to meet our growing load was natural gas. Within one week of the 1999 decision, we announced our plan to build outside of APS new natural gas generation on an expedited schedule to meet anticipated load growth. Even then, APS had to lease temporary generation in 2001 when its reserve margins fell to unacceptable levels by any industry standard. The five-year dialogue on competition, competitive regional markets, regional competition plans and FERC independent scheduling organizations had reduced our practical resource options to one - natural gas. Looking forward, however, Arizona must remain committed to keeping all options open.

Rebuilding APS's financial strength to the point where it and the Commission can once again evaluate all future resource options rather than reluctantly resigning our customers to more gas-fired generation will not happen overnight. However, it will not happen, or at least will not happen in time to avoid such a one-fuel future, unless we begin now.

D. Energy Independence

Arizona has had the ability to determine its energy future in the past by aggressively making major resource additions. Most recently, when California experienced the debacle of deregulation, APS was able to meet our customer's rapidly growing needs while simultaneously reducing prices. This was possible because we had sufficient capacity that had been planned, constructed and given rate treatment over several prior years. Given the regional and interconnected nature of our electric grid, we are mutually dependent on other providers and consumers without regard to political boundaries and therefore, we must consider our demand/supply relationship over long time horizons. This necessarily places more emphasis on forecasting and the associated construction/contracting decisions. The most accurate forecasting and the most sophisticated planning processes are meaningless without action to achieve them. There must be a commitment on the part of regulators to support with positive regulatory actions the decisions that they and the utility make with regard to the direction and goals of construction/contracting decisions. Only through this common commitment can we lessen our operational dependency on the policies of other states, thus providing our state with continued energy independence.

E. Cost Management and Efficiency

We are very focused on cost management and employee productivity. As I indicated earlier, I firmly believe the Company's goals and those of this Commission are fully consistent. No place is this truer than in the areas of cost management, efficiency and productivity, and customer service. APS announced earlier this year and again very recently additional steps to reduce costs and improve efficiency. These measures, although necessary to improve cash flow and modestly improve the Company's relative financial condition, will not be sufficient to achieve the financial strength needed. Indeed, they are complementary to the interim rate relief requested in this proceeding. Even combined with such relief, APS remains in a significant, albeit improving (and that is the key thing) deficit position (see Mr. Brandt's Affidavit at 7-9).

APS realizes that this Commission wants APS to be as efficient and cost conscious as possible given the needs of reliability and customer service. I believe that the Commission's own audit of APS's fuel/purchased power procurement and handling practices, the Commissions consultants' reports on the operation of our generating facilities as part of the last rate proceeding (and thereafter, with regard to the review of 2006 outages at Palo Verde), the review of our distribution reliability and the extensive evaluations performed by Commission Staff witnesses in the hearings over the past several years all show APS is operating prudently and efficiently. That conclusion is further supported by our own internal "apples to apples" cost benchmarking data that show we consistently perform well when compared to our peers in the industry.

Finally, I would note in this regard that cost management alone will not rebuild our financial strength. Although cost management is and will remain a driving force and a core principle of this Company in mitigating the very significant effects of commodity cost inflation combined with continued growth, it cannot solely compensate for the impacts of regulatory lag. I also believe that we should avail ourselves of every cost effective tool and technology in the market that will increase efficiency and help to control costs. But this again will require a financially strong APS.

F. Reducing Rate Volatility

APS prices recently declined due to the operation of the power supply adjustment clause implemented by this Commission. We have proposed this interim price increase that would offset this decrease because it will improve APS's financial strength at this critical time, send an appropriate price signal to customers, and yet at the same time, the overall impact on our customers will be lessened. We fully appreciate the distinction between the PSA decrease and this requested interim increase. We also understand that the decline in electric rates during the winter is a regular seasonal event for most APS customers. It is not our intent to confuse one with the other. It simply is an opportunity to reduce the impact of a rate increase today as well as the impact of a final decision on the permanent rate request. No one likes to increase prices, and APS understands the effect this has on our customers. However, the impact of not increasing prices for electricity when the costs are increasing has an even greater and decidedly negative effect on customers over the long term.

IV. CONCLUSION

Q. DO YOU HAVE ANY FINAL COMMENTS?

A. Yes. In summary, this Commission should approve the interim request to (1) reduce regulatory lag; (2) send a strong message to the capital markets and to the industry as a whole that the Commission shares with APS the goal of acquiring capital at the lowest possible cost consistent with high customer service and reliability; (3) improve APS financial strength consistent with the ability to finance new base load additions; (4) maintain Arizona's energy independence; (5) support the investment necessary to improve efficiency and manage costs; and (6) minimize the impact of price increases by implementing such rates coincident with the change to winter rates in November and reducing the increase in permanent rates determined in the Company's base rate request by a like amount.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.

REBUTTAL TESTIMONY OF DONALD E. BRANDT

On Behalf of Arizona Public Service Company

Docket No. E-01345A-08-0172

(Interim Rate Request)

September 8, 2008

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REBUTTAL TESTIMONY OF DONALD E. BRANDT
ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY
(Docket No. E-01345A-08-0172)
(Interim Rate Request)

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME, ADDRESS AND OCCUPATION.

A. My name is Donald E. Brandt. I am President and Chief Executive Officer of Arizona Public Service Company ("APS" or "Company") and President and Chief Operating Officer of Pinnacle West Capital Corporation ("Pinnacle West"). I am responsible for all aspects of APS operations, including generation, transmission, distribution, customer service, and general administrative functions. My business address is 400 North 5th Street, Phoenix, Arizona, 85004.

Q. HAVE YOU PREVIOUSLY SUBMITTED TESTIMONY IN THIS PROCEEDING THAT DESCRIBES YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND?

A. Yes. In addition to the Affidavit that I submitted in this interim proceeding (which serves as my Direct Testimony in this matter), I have also submitted Direct Testimony in the general rate case, which describes my educational and professional background.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. The purpose of my Rebuttal Testimony is to respond to the Direct Testimony submitted by other parties in this proceeding. I will address three general areas: (1) why interim relief is appropriate for APS under the extraordinary challenges it is facing today; (2) the amount of interim relief that is warranted; and (3) why it is contrary to the public interest to condition the approval of interim relief or the timing of such an award on an issuance of equity by Pinnacle West.

II. SUMMARY

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. I will begin by making some general observations about the testimony submitted by the various parties to this proceeding. Although there clearly are several areas of disagreement between APS and the other parties, there are also many important concepts and facts on which we agree or about which there appears to be no dispute:

- Interim relief can be appropriate even under certain "non-emergency" conditions, including when "the Commission is unable to process a utility's rate increase request in a timely manner" or "if other special circumstances are present." *See* Direct Testimony of Ralph C. Smith ("Smith Testimony") at 8.

- Credit ratings matter and are a relevant consideration in this proceeding. *See* Smith Testimony at 24-25, 32; Direct Testimony of David C. Parcell ("Parcell Testimony"), throughout.

- A downgrade of APS to non-investment or "junk" credit status would be undesirable and would increase costs to both the Company and customers, and it is therefore desirable to protect APS from a ratings downgrade. *See* Smith Testimony at 25.

- APS's rates are set using a historical test year coupled with rate cases that take between 18 to 24 months to complete. *See* Smith Testimony at 23.

- APS has faced and continues to face extraordinary capital expenditure requirements necessary to maintain its existing system, meet increasing demand, and perform environmental upgrades on generation plants. These capital expenditure needs are exacerbated by commodity cost inflation and foreign exchange pressure, factors entirely outside of the Company's control. *See* Affidavit of Donald E. Brandt ("Brandt Affidavit") at 5-6 (undisputed).

- Under even a basic "non-controversial" analysis of net rate base additions since the last APS rate case, APS's ACC-jurisdictional rate base has increase by over a half a billion dollars ($1.114 billion of new investment as of December 31, 2007, net of accumulated depreciation), which is not reflected in the rates – an amount that does not include any of the significant plant additions placed in service since December 31, 2007 or the impact of book depreciation on any new plant additions. *See* Smith Testimony at 33.

- APS is currently realizing Returns on Common Equity ("ROE") well below its authorized 10.75% rate of return. Under present rates, the Company's actual ACC-jurisdictional ROE was only 9% in 2007, and falls to 8.4% in 2008 and 6.3% in 2009 absent rate relief, resulting in a tremendous earnings shortfall. As a result, APS faces the loss of $384 million in authorized ACC-jurisdictional earnings (assuming a 10.75% ROE) from the end of the December 31, 2007 Test Year through 2010 (which is additive to and more than doubles the $321 million earnings shortfall that APS has experienced over the past five years). *See* Brandt Affidavit at 7 (undisputed).

- The Company's subpar financial performance has caused Pinnacle West's stock price to fall below book value, with stock performance that ranks dead last compared to that of its industry peers. *See* Brandt Affidavit at 9-10 (undisputed).

These acknowledged or apparently undisputed facts show that, contrary to Staff's consultants' and RUCO's respective conclusions, the impact of regulatory lag on APS is anything but "ordinary." In the current operating environment, beset by severe inflation in core commodity costs, increasing global demand, the falling value of the dollar in the foreign exchange market, vigorous competition for utility capital, and challenging credit and capital markets in the face of unprecedented future capital expenditure requirements, the excessive regulatory lag is debilitating to the Company's financial health and its ability to maintain investment grade credit metrics during the course of the Company's general rate proceeding. Further, none of these external factors can be substantially offset by "cost management." These are the very type of "special circumstances" that justify the granting of interim relief.

Staff's consultants do not dispute that public policy requires APS to be kept financially sound or the fact that APS suffers from an earned ROE far below its authorized ROE and a declining FFO/Debt ratio. Rather, they understate the significance of those factors to APS and its customers by simply questioning APS's assertion that, as a result, the Company will likely face a ratings downgrade before any new rates from the general rate case will take effect. As I will show, their analyses of how the credit rating agencies perceive APS reflect neither how credit rating agencies operate nor the pivotal significance of APS's declining credit metrics – particularly the highly important FFO/Debt ratio.

Under the extraordinary circumstances presented in this case, simply hoping that permanent rate relief will come through in time to prevent a downgrade to junk is both dangerously reckless and contrary to the public interest. It is not prudent public policy to permit Arizona's largest electric utility to be kept teetering on the brink of junk status, particularly given the significant challenges and opportunities facing the State's energy future. The goal cannot be to keep APS at an 18% FFO/Debt level and earning far below its authorized ROE, with no buffer against external factors and limited ability to invest both in basic infrastructure and in the resources, programs and technologies that will contribute to an efficient, sustainable, and reliable energy future for the Company's customers. Rather, these circumstances require proactive, innovative measures, including interim rate relief, to mitigate the extraordinary impact of regulatory lag, protect APS from downgrade, and give APS the financial wherewithal to provide its customers and the State with the important benefits that the Company – and, I believe, the Commission – have deemed to be necessary and in the public interest.

III. <u>THE COMPANY IS CURRENTLY FACING EXTRAORDINARY CONDITIONS THAT JUSTIFY THE AWARD OF INTERIM RELIEF.</u>

A. Interim relief is not dependent upon the showing of an emergency.

Q. DO YOU AGREE WITH RUCO'S ASSERTION THAT INTERIM RELIEF MAY BE GRANTED ONLY UPON THE FINDING OF AN EMERGENCY?

A. Although this is a legal issue that I expect the parties will brief, it is my understanding, from both the Company's legal analysis (reflected in the Company's Motion for Interim Relief) and my own observation from other cases, that an emergency is not required. Even as Staff Witness Smith articulates it, no finding of "emergency" must be made for interim relief to be appropriate. As Mr. Smith notes, in his experience, interim rates may be granted under any of three circumstances, two of which do not require an "emergency": "if the Commission is unable to process a utility's base rate increase in a timely manner, if the utility is experiencing an emergency, or if other special circumstances are present." *See* Smith Testimony at 8.

I cannot imagine that the framers of the Arizona Constitution gave the Commission broad authority over utility rates, yet would proscribe that authority to limit the Commission's ability to proactively address the extraordinary circumstances that confront APS today. I agree with an analogy that Commissioner Pierce drew during the Procedural Conference in this matter: that it is important to clear the trees from the forest before the fire arrives, rather than trying to protect the area's residents from harm in the heat of the flames.

B. Under Staff's articulated standards, APS has shown that interim relief is appropriate under the Company's current circumstances.

Q. HOW DO YOU RESPOND TO MR. SMITH'S AND RUCO'S SUGGESTION THAT APS'S REQUEST FOR INTERIM RELIEF SHOULD BE DENIED BECAUSE "ORDINARY" OR "NORMAL" REGULATORY LAG "BY ITSELF" DOES NOT JUSTIFY INTERIM RELIEF?

A. Such statements are irrelevant here since APS is experiencing anything but "ordinary" or "normal" regulatory lag. To the contrary, APS is experiencing **extraordinary** regulatory lag in the face of **extraordinary** operating conditions, causing the Company significant (and undisputed) financial harm, and threatening the Company's ability to protect itself from a ratings downgrade during the course of the general rate proceedings. These conditions are the very "special circumstances" that warrant interim relief under Staff's own articulated standards. *See* Smith Testimony at 8, 32.

Q. PLEASE EXPLAIN WHAT YOU MEAN WHEN YOU SAY THAT APS IS EXPERIENCING "EXTRAORDINARY" REGULATORY LAG?

A. It is undisputed in this case – and well known (and often mentioned) by credit rating agencies and analysts – that rate cases for APS have historically taken 18 to 24 months to complete. This extensive period of regulatory lag is longer than that of virtually every other jurisdiction in the country and, given the lack of any compensating mechanisms, the most damaging. As one utility research and analysis firm recently commented, "**the extent and consistency of the exorbitant regulatory lag in Arizona is without comparison in the industry**." *See* Regulatory Research Associates, Utility Focus on Pinnacle West Capital, March 14, 2008, attached hereto at Attachment DEB_RB-1. As I noted in my Affidavit, credit rating agencies also routinely comment on Arizona's extensive regulatory lag as one of the challenges that APS must overcome if it is to remain investment grade.

Compounding the cost recovery issues inherent in such regulatory lag, the Commission also uses a historical test year, which Staff has recently suggested means a test year that requires significant experience under present rates. This means that the current regulatory framework could, for example, prevent APS from even beginning to recover prudently incurred costs for up to **three years** after that investment was made and the plant was placed in service. Such extraordinary delay under the Company's current operating conditions institutionalizes economic confiscation of invested capital and causes APS significant financial harm that threatens its already precarious credit metrics.

Moreover, contrary to Mr. Smith's suggestion, such a regulatory regime does not simply require the Company "to bear the cost of new plant additions temporarily." *See* Smith Testimony at 13. Because depreciation expense, property taxes and capital carrying costs begin for new investments the moment that they are placed in service, regulatory lag deprives the Company of the ability to **ever** recover some of those costs. The resulting **permanent** loss of revenue is both substantial and debilitating when the required investments are as great and the lag time is as long as both are now for APS.

Q. PLEASE DESCRIBE THE "EXTRAORDINARY CONDITIONS" TO WHICH YOU EARLIER REFERRED.

A. As I described in my Affidavit and in greater detail in my Direct Testimony for the general rate case, APS has faced and continues to face extraordinary capital spending requirements that are necessary for APS to maintain the reliability of its existing system, meet increasing demand, perform environmental upgrades on its aging generation plants, and invest in the technologies that APS (and, I believe, the Commission) has determined to be important for customers and consistent with the public interest. These cost pressures are exacerbated by a number of external financial pressures that are entirely outside of the Company's control, including corrosive inflation of the Company's core commodities costs, the falling value of the dollar in the foreign exchange market, increasing competition for utility capital, and difficult and volatile credit and capital markets.

Importantly, the fact that APS is challenged by these rising costs was not disputed by Staff or any other party to this proceeding. Nor can it be. As described in an analysis recently conducted by the Federal Energy Regulatory

Commission ("FERC") into the causes of and responses to rising electricity costs, APS's cost pressures are shared by utilities across the nation, and are reflected in rising costs of electricity nationwide. The FERC report notes that electricity prices are rising because of unprecedented cost increases, including significant capital expenditure costs related to the need for sizeable new investment in generation, distribution, and transmission construction that are inflated by, among other things, rising global demand for basic materials, increasing labor costs, and uncertainty about the financial impact of future climate change legislation. This rising cost trend is also observable elsewhere in Arizona. Salt River Project ("SRP") – Arizona's second largest utility, next to APS – has increased rates by 26.7% since 2002 and has recently requested that its Board of Directors approve a second rate increase of another 5% to 7%, which, if approved as requested by November 1 of this year (so that the increase would phase-in with SRP's lower winter electric prices, exactly as APS has requested here), would raise SRP's rates by a total of over **30%** in just the past six years. *See* page D1 of the Arizona Republic, September 6, 2008.

Characterizing the cost pressures facing the electric utility industry, FERC Chairman Joseph Kelliher concluded, "[w]e must accept that the U.S. cannot make the massive investments necessary to assure security of our electricity supply, make additional large investments to confront climate change, and lower electricity prices at the same time. If we try to do all three, the result will likely be failure." *See* Attachment DEB_RB-2. Similar studies reaching almost identical conclusions were attached to my general rate case testimony at Attachment DEB-2.

Q. WHAT IMPACT HAVE THESE EXTRAORDINARY COST CONDITIONS HAD ON THE COMPANY'S FINANCIAL HEALTH?

A. The Company's capital investment requirements, coupled with extensive regulatory lag, have caused its cash outflows to far exceed cash inflows – deficit spending that results in a significant deterioration of the Company's financial health and requires APS constantly to battle to maintain investment grade credit metrics that lie just on the brink of "junk" credit status. This is hardly a desirable condition for Arizona's largest utility, with the duty to provide reliable service to over one million Arizonans.

Significantly, no party to this proceeding disputes the negative impact that the current operating environment has on APS's financial condition to any real degree. Staff's consultant, Mr. Smith, asserts – without any substantiating evidence or analysis – that there "may not" be merit to the Company's contention that its incremental revenues are insufficient to keep up with its growing costs. But that suggestion is undercut both by (1) the independent assessment by S&P cited on page 18 of Mr. Smith's testimony, noting that APS's significant capital spending needs are "expected to drive negative free operating cash flows for the foreseeable future"; and (2) Mr. Smith's ultimate conclusion that, under the most basic "non-controversial" analysis, the Company has invested $538 million in net ACC-jurisdictional plant necessary to serve customers that is not reflected in rates. The latter point makes it self-evident that APS's revenues have not been sufficient to meet its growth in rate base. *See* Smith Testimony at 12-14.

Neither does any party contest that credit rating agencies are well-aware of the debilitating impact of APS's unusually protracted regulatory lag on the

Company's financial condition under these circumstances. This critical point is underscored in the June 2008 S&P report quoted at length on page 18 of Mr. Smith's testimony, which notes that "[t]he use of a historical test year in Arizona, coupled with the fact that fully litigated rate cases take between 18 to 24 months to complete, is expected to result in no meaningful improvement in financial performance through 2009 and possibly beyond, depending upon the timing and the outcome of the company's current case." However, Mr. Smith omitted to include in his lengthy quotation the ultimate conclusion that S&P reached in that report: that, notwithstanding the currently "stable" outlook, "[r]atings could be lowered to speculative grade if the company is not able to overcome the challenge of ensuring timely recovery of its prudently incurred costs through rate increases approved by the ACC." *See* Attachment RCS-2 to Mr. Smith's Testimony at 22.

As APS has repeatedly made clear in this and other matters, the Company's inability to timely recover its investment has deprived it of the opportunity to actually earn its allowed rate of return for the past several years – a fact undisputed by any party to this proceeding. Going forward, APS projects to earn a mere 8.4% ACC-jurisdictional ROE in 2008 (compared to its allowed return of 10.75%), a number that falls to 6.3% in 2009 without intervening rate relief – again, facts that are not disputed by any party to this proceeding. As a result, APS faces the loss of $384 million in authorized ACC-jurisdictional earnings (assuming a 10.75% ROE) from the end of the December 31, 2007 Test Year through 2010 (which is additive to and more than doubles the $321 million earnings shortfall that APS has experienced over the past five years).

The Company's earnings attrition is entirely related to the fact that its present rates do not compensate the Company for its non-fuel cost-increases. Such subpar financial performance has placed in serious risk the Company's ability to attract at a reasonable cost the capital necessary to finance its capital program and damaged its credit metrics, causing them to hover at dangerous levels during the course of the Company's general rate proceedings absent proactive, pre-emptive Commission action.

Q. YOU MENTIONED THAT UTILITIES ACROSS THE NATION FACE THE SAME COST PRESSURES AS APS. ARE THESE UTILITIES EXPERIENCING THE SAME FINANCIAL HARM THAT YOU HAVE DESCRIBED FOR APS?

A. Generally not. Although utilities across the nation are challenged by many of the same cost pressures now facing APS, most perform far better financially compared to APS and have secured much higher credit ratings. As explained in my Affidavit, APS's credit ratings on its outstanding debt are among the very worst of the industry, with only five of the 139 investor-owned electric utilities rated by S&P rated lower than APS. *See* Brandt Affidavit at 11. And while Staff consultant David Parcell attempts to show that the Company's bond ratings are only **"somewhat less"** than those of other electric utilities, his position is at odds with the very evidence he cites – a table generated from an August 2008 AUS Utility Report (correcting the table printed on page 10 of Mr. Parcell's Testimony, in response to a discovery request from APS), which demonstrates that, of the 47 companies included in the report rated by Moody's, only **4** are rated worse than APS (with **23** such companies rated higher), and that S&P rated only **1** of the 50 utilities included in the report below APS (with **40** such companies rated higher). *See* Staff Response to APS 3.1, attached hereto at Attachment DEB_RB-3.

APS's comparatively worse credit ratings are unquestionably linked to its inability to overcome the financial challenges posed by the Company's capital requirements in its current regulatory environment and the undeniable fact that our prices are below costs. Unlike other jurisdictions with utilities facing similar cost-challenges, Arizona has no mechanism in place to mitigate the deleterious impact of regulatory lag on APS's ability to recover its substantial non-fuel costs. Such mechanisms include, for example, the use of a future test year in setting rates so that future revenues are better aligned with future costs, thus mitigating the earnings attrition impact of regulatory lag. States using such a mechanism include Alabama, Arkansas, California, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Maryland, Minnesota, Mississippi, North Dakota, New Jersey, New York, Pennsylvania, and Wisconsin.

For those states, like Arizona, that use a historical test year in setting rates, many require that rate cases be resolved within a short time frame – often six to ten months or less – in order to avoid the negative financial impact of protracted regulatory lag. In Arkansas, for example, rate cases must be resolved within 10 months, or utilities are permitted to automatically place proposed rates in effect under bond and subject to refund pending the completion of the rate case proceedings. In Connecticut, rate cases must be completed in six months, or the proposed rates may become effective until the rate case is resolved, subject to refund. Delaware requires that rate cases be finalized in seven months, permits interim rates after 60 days, and utilities may automatically place any requested increase not above 15% into effect subject to refund if the seven months timeframe is not met. In Mississippi, if a rate case is not complete within four months, the full request may be implemented under bond subject to refund. Numerous other states provide for interim rates to be implemented if a case is not decided within a specified timeframe, often six to 10 months, including Connecticut, Georgia, Kansas, Kentucky, Mississippi, New Hampshire, Oklahoma, and Utah. The more general use of interim rates to mitigate the impact of regulatory lag is permitted in Arkansas, Delaware, Florida, Hawaii, Iowa, Maine, Montana, New Jersey, North Dakota, Oregon, Rhode Island, Texas, and Virginia.

APS is also aware of several jurisdictions, in addition to Arizona, that have allowed explicit "attrition" adjustments, index adjustments, or other mechanisms to protect against the negative impacts of regulatory lag. For instance, Alabama has implemented a mechanism pursuant to which a utility's rates are reviewed annually under a forecasted test year, and are adjusted to ensure that Alabama's utilities are earning an allowed 13.0% to 14.5% ROE. Under a corollary "Earnings Sharing Mechanism," if the utility earns in excess of 14.5%, customers are fully refunded the overage at the time of the annual adjustment. No "traditional" rate cases have been filed in Alabama since this plan was implemented. Similar "earnings sharing," "attrition" or indexed adjustment mechanisms are used in jurisdictions including California, Georgia, Iowa, Louisiana, Maine, Massachusetts, Mississippi, North Dakota, Oklahoma, and Vermont.

As the foregoing shows, regulatory jurisdictions throughout the country are taking proactive, innovative steps to reduce the negative earnings impact of regulatory lag on their respective states' utilities. Disregarding those significant impacts out of strict adherence to "tradition" is neither reasonable nor constructive, and will ultimately harm APS, its customers and the State of Arizona over the long-term.

Q. THE COMMISSION HAS RECENTLY APPROVED SEVERAL ADJUSTMENT MECHANISMS FOR APS. DO THOSE MECHANISMS HELP RELIEVE THE COMPANY'S FINANCIAL CONDITION?

A. APS currently has in place several Commission-approved adjustment mechanisms that have improved the Company's previous cash flow problems, including particularly the Power Supply Adjustor ("PSA") and the Transmission Cost Adjustor ("TCA"). APS acknowledges these constructive measures, some of which have unquestionably forestalled a downgrade to junk to date. There is little question that, by resolving the Company's significant fuel cost recovery problems, the PSA in particular saved the Company from a downgrade following the conclusion of the last rate case, and, in all likelihood, protected APS from financial insolvency.

Nevertheless, it is important to recognize that, except for the TCA, these mechanisms are simply operating cost pass-through provisions, which do **not** provide earnings to the Company. The PSA, for example, does not prevent the Company's growing earnings attrition and thus cannot resolve the fundamental financial difficulties caused by APS's increasing non-fuel costs in an environment of extensive regulatory lag.

Q. HOW DO YOU RESPOND TO STAFF'S DISCUSSION OF THE "USEFUL FUNCTIONS OF REGULATORY LAG" ON PAGES 12 AND 13 OF MR. SMITH'S TESTIMONY?

A. I am responsible for running an electric utility that has a legal obligation to provide reliable service to both current and – just as important – future customers, irrespective of whether the cost of doing so outweighs the immediate financial benefit to APS of whatever incremental revenue those customers provide. Mr. Smith's suggestion that APS has the luxury of simply rejecting projects that do not survive some sort of "cost-benefit analysis" ignores the Company's duty to serve and anticipate the future needs and opportunities facing our State.

It is undeniable that APS has an obligation to provide reliable service to every present and future customer residing in its service territory, and, as the designated "provider of last resort," must remain ready and able to connect even those customers that do not receive service from APS today but that might someday request it. This means that APS is required not only to maintain a reliable distribution and transmission system that can serve present and future customers, but that it must also invest in (or otherwise acquire) the generation resources necessary to meet all of the growing energy demand within its service territory. As Arizona's largest utility, the Company is also keenly aware of its responsibility to comply with the Commission's policy directives to invest in resources and technologies that will promote a sustainable energy future for Arizona and allow Arizona's economy to continue to prosper (as APS Witness Bill Post discusses in his Rebuttal Testimony).

Significantly, neither Staff's consultants nor any other party to this proceeding disputes that most, if not all, of APS's capital costs are essential for APS to maintain reliable service, meet demand, and continue to implement the customer-beneficial programs and technologies that this Commission has found to be in the public interest. The massive costs facing APS thus cannot be avoided without sacrificing either service reliability or Commission-endorsed, customer-beneficial programs, and the Company simply cannot "cost manage" its way into financial health during the extensive period of regulatory lag by performing a "cost/benefit" analysis on its intended capital projects and rejecting as an inappropriate business risk any project that "is not cost-justified or [for which] the benefits are too speculative to warrant the commitment of funds," as Mr. Smith suggests. *See* Smith Testimony at 13.

If APS is required to continue to bear the entire "cost responsibility for plant additions and operating cost increases during the period between rate cases," notwithstanding the extraordinary length of such period and the fact that such lag results in a permanent forfeiture of earnings, loss of financial health, and deteriorating credit metrics (as Mr. Smith suggests regulatory policy requires), socially desirable and customer-beneficial projects will necessarily be sacrificed in favor of whatever investments APS can still afford to make to meet its obligation to provide basic, reliable service to its customers. The Company never wants to be placed, for example, in the position that PacifiCorp's subsidiary, Rocky Mountain Power, is now in: PacifiCorp recently announced that, because the Utah public utility commission did not grant Rocky Mountain Power a rate increase that was sufficient to cover its cost of providing electric service, it would be forced to terminate services aimed at ensuring the reliability of its system (such as the payment of overtime to employees to promptly respond to system outages, except where public safety is threatened). *See* PacifiCorp Press Release, September 2, 2008, attached hereto at Attachment DEB_RB-4.

If APS is downgraded during the course of its general rate proceedings, as I believe is more likely than not without interim relief, there is a virtual guarantee that even the currently planned Solana project will be abandoned in light of a contractual clause in the Company's contract with Abengoa that allows Abengoa to forego the project if, because of APS's financial condition, Abengoa cannot obtain the necessary financing to complete it. As the Company's CEO, I have gone on record saying that we intend for Solana to be the first of several large-scale central-station solar projects, and have set an ultimate goal of making Arizona the solar capital of the world. A credit downgrade to junk would devastate that vision.

Q. **HOW DO YOU RESPOND TO STAFF'S AND RUCO'S SUGGESTION THAT THE USE OF INTERIM RELIEF TO MITIGATE THE FINANCIAL HARM CAUSED BY REGULATORY LAG UNFAIRLY SHIFTS RISK FROM THE COMPANY TO RATEPAYERS?**

A. Such a suggestion is far off the mark. In the most simple terms, APS is entitled to rates that are sufficient to cover its operating and capital costs and provide a meaningful opportunity to earn a reasonable return on the fair value of its property. There is no legal or regulatory principle that requires the Company to forego this entitlement for **any** period of time – let alone a two year or longer period of regulatory lag.

The Company's current rates do not allow APS to recover its cost of service, nor have they for years. Mr. Smith concedes that, just since the end of the September 30, 2005 test year from APS's last rate case, APS has invested in at least half a billion dollars in ACC-jurisdictional rate base necessary to serve customers that is not reflected in the Company's present retail rates. *See* Smith Testimony at 12. For every additional day that APS is unable to recover these costs, the Company's financial condition worsens.

There is nothing unfair in requiring customers to pay for the Company's reasonable cost of service, nor can such a requirement be characterized as inappropriate "risk shifting." In fact, the opposite is true. For years, APS's shareholders have sacrificed expected and allowed returns while still contributing to the financial health of the Company through equity infusions. At the same time, APS's customers have received exceptional and reliable service at below-cost, shareholder-subsidized prices. Such an arrangement is simply not sustainable. The Company's financial condition grows more precarious, Pinnacle West's stock is selling for below book value and consistently performs worse than its peers, and APS relentlessly hangs on the edge of investment grade credit status, threatened with a downgrade to junk. The striking financial impact of the extensive regulatory lag that we are experiencing today must be addressed if APS is to avoid the threat of a credit rating downgrade and continue to meet its public service obligations in the future. Granting the Company's interim request is one important way in which the Commission can do so.

C. Staff's consultants' conclusion that APS's financial condition is currently strong enough not to require interim relief ignores the significant risks now facing the Company.

Q. HOW DO YOU RESPOND TO MR. SMITH'S SUGGESTION THAT "APS'S FINANCIAL CONDITION APPEARS TO BE SOUND ENOUGH TO NOT REQUIRE AN INTERIM INCREASE DURING THE PROCESSING OF ITS GENERAL RATE CASE" (*SEE* SMITH TESTIMONY AT 30)?

A. First, Mr. Smith's use of the qualifier "appears" should give the Commission pause, given the striking and undisputed consequences of his being wrong. Second, and despite Mr. Smith's and Mr. Parcell's belabored attempts to suggest otherwise, the evidence is clear that APS's financial condition is suffering from the impact of the extraordinary circumstances it now faces, that its ability to continue to invest in necessary capital projects is in jeopardy, and that it faces a substantial risk of downgrade during its general rate case proceedings without rate relief.

Staff's consultants fail to address the most fundamental issue – whether, absent interim relief, there is a reasonable risk that APS will be downgraded, be unable to secure needed capital, or be forced to forego needed and beneficial projects prior to the resolution of the Company's general rate case. Instead, Mr. Smith and Mr. Parcell engage in a lengthy and distracting discussion of how credit rating agencies rate utilities and a selective analysis of recent rating agency reports in an attempt to show that APS is **at the moment** sufficiently "sound" financially.

This argument appears to be premised on three factors: (1) that APS's debt is currently investment grade, *see* Smith Testimony at 23, 25; (2) that credit rating agencies have not indicated that interim relief is required to maintain that investment rating, *see* Smith Testimony at 25; and (3) that APS is not currently experiencing a financial crisis, Smith Testimony at 16. From this, Staff concludes that **"[u]nless there are unanticipated or unforeseen events that occur during that timeframe** . . . APS should be able to continue to provide safe, reasonable, and adequate service without an interim rate increase while the APS general rate case is being processed." *See* Smith Testimony at 15.

But that is not the standard for interim relief, nor should it be. Although APS's debt may currently be rated investment grade, the Company's credit metrics are such that the rating may fall to junk in the blink of an eye. And although APS currently has access to the debt capital markets, given the Company's financial condition and the current state of the debt markets, that access, too, may be denied on a moment's notice (as it has been in the past), and APS cannot meet all of its spending needs for the next several years with existing revolving credit agreements, as Mr. Smith appears to suggest it should. *See* Smith Testimony at 16, 28.

Prudent public policy requires keeping the state's largest utility in sufficient financial health at **all times** such that it has the financial wherewithal to overcome the financial challenges posed by any "unanticipated or unforeseen events" that may occur so that the highly negative consequences of such events can be avoided at the outset, rather than dealt with after the event occurs and it is too late to avoid the harm. Contrary to the suggestion of Staff's consultants, this means that the Commission must do more than simply examine the state of the Company's financial health as it exists at this very moment, but must look at the reasonable future risks facing APS to determine whether interim relief is appropriate. You do not wait to start building the ark until after you see the first drop of rain.

Q. WHY DO YOU BELIEVE IT IS MORE LIKELY THAN NOT THAT APS WILL LIKELY BE DOWNGRADED TO JUNK DURING THE COURSE OF THE COMPANY'S GENERAL RATE PROCEEDING?

A. I firmly believe that APS faces the significant threat of downgrade during the course of the Company's rate proceeding because it does not have sufficient revenue to sustain its FFO/Debt credit metric above investment-grade levels during the course of the Company's general rate case, much less any financial cushion to protect it from any financial difficulty that may occur during that time.

Irrespective of the admittedly general description outlined by S&P of what criteria a utility must maintain to remain within investment grade (a discussion that was overly simplified on pages 12 and 13 of Mr. Parcell's testimony), it remains true that – for a company with the regulatory and other challenges facing APS – the Company still must have an FFO/Debt ratio in the range of 18% to 20% in order to avoid a downgrade to junk. Although I agree with Staff that the FFO/Debt metric is not the "exclusive" metric analyzed by rating agencies (by describing it as 'key," I do not believe I ever suggested otherwise), it is indisputably the most important one – a fact that is commonly known in the industry and made clear by the very articles Mr. Smith cites in his testimony.

In the 2008 S&P publication describing "Corporate Ratings Criteria," attached to Mr. Smith's testimony at RCS-3, S&P plainly states that funds from operations is "the most frequently used credit measure in industrial ratings," and that cash flow adequacy analysis, usually the "single most critical aspect of credit rating decisions," "often focuses on levels of funds from operations (FFO)." *See id.* at 40-42. The Company's concentration on FFO/Debt is therefore most appropriate in attempting to discern generally when its credit metrics will be sufficiently low to make a downgrade a reality.

As APS has shown, even assuming an equity issuance of $400 million before year end 2009, the Company's FFO/Debt ratio will fall below the 18% threshold to junk just next year, resting at 17.6% by year end 2009 and 16.6% in 2010 under present rates – well outside of the parameters needed to sustain investment grade.

Q. PLEASE ADDRESS THE TABLE ON PAGE 20 OF MR. SMITH'S TESTIMONY, WHICH PURPORTS TO SHOW THAT APS'S FFO/DEBT RATIO WILL REMAIN AT INVESTMENT GRADE LEVELS WITHOUT INTERIM RELIEF.

A. Mr. Smith's attempt to use the data shown in the table on page 20 to prove that APS's FFO/Debt ratio can be sustained within investment grade levels even without interim relief is unpersuasive because it is based on a set of assumptions (which he expressly **required** in his data request) that are inherently implausible.

For example, the table assumes that APS will receive a base rate increase of anywhere from 9.5% to 17.5% on October 1, 2009. This assumption is shaky for a couple of reasons. First, it ignores the undisputed fact that APS rate cases have historically taken anywhere from 18-24 months to resolve, which would make any new rate that APS is granted in its permanent rate case effective in 2010, at the earliest. While APS hopes that the case will be resolved by October 1, 2009, as requested, it nonetheless questions whether it will benefit from permanent rate relief in this timeframe.

Moreover, the assumed level of rate increase is made without the benefit of *any* indication of what level of rate increase Staff, RUCO, or any of the other parties to the rate case (let alone the Administrative Law Judge or the Commission) will support. While the Company certainly hopes that it receives **at least** a 9.5% rate increase at the conclusion of its general rate case (and it needs much more, as that filing shows), Staff has made no such recommendation and it would be imprudent to **depend upon** any such level of relief for purposes of the interim proceeding before knowing what the analysis and recommendations of other parties will be.

The results in the table also assume that APS is able to receive an equity infusion from Pinnacle West under reasonable terms in 2008 – a virtual impossibility considering current timing, current market conditions and Pinnacle West's below-book-value stock price, not to mention the difficulty that Pinnacle West would have attracting equity investors on reasonable terms while APS is knee-deep in litigating a general rate case after having been denied interim relief (the premise of Staff's position) with a history of substantially underearning its allowed ROE by significant margins. These and other practical restraints that I will describe in detail below will likely prevent the Company from benefiting from any equity infusion before well into 2009, despite Mr. Smith's assumption to the contrary.

Give the likely unrealistic assumptions underpinning these results, Mr. Smith's analysis cannot be used as a basis for concluding that the Company's credit metrics are sufficiently sound without interim relief that it will be able to avoid a downgrade should interim relief not be granted.

Q. HOW DO YOU RESPOND TO STAFF'S CONSULTANTS' ARGUMENT THAT APS'S CURRENTLY "STABLE" OUTLOOKS PROVE THAT APS WILL NOT BE DOWNGRADED WITHOUT INTERIM RELIEF?

A. Staff's consultants attempt to use rating agency reports to undercut APS's claim that it will likely be downgraded prior to the conclusion of its general rate case misunderstands how rating agencies operate. As an initial matter, each of the "stable" outlooks published by the rating agencies anticipates constructive decisions in the Company's interim and general rate filings that will allow it to maintain its current investment grade levels. Moody's, for example, notes that its "stable" outlook for APS is specifically predicated on the expectation "that more balanced regulatory relief continues especially given that APS has several rate filings currently pending" (referring to both the interim and general rate matters). *See* Parcell Testimony, Attachment 8.

Similarly, the June 2008 S&P ratings report on which Mr. Smith and Mr. Parcell rely expressly notes that the Company's interim request was a consideration in that agency's "stable" outlook for APS, stating that "[t]he stable outlook reflects our expectation that consolidated cash flow volatility has been tamped down by the ACC's approval of a stronger PSA that speeds the recovery of fuel costs, but consolidated financial performance will continue to be challenged by regulatory lag at APS, which could be moderated by APS's pending interim rate request . . . . Ratings could be lowered to speculative [junk] grade if the company is not able to overcome the challenge of ensuring timely recovery of its prudently incurred costs through rate increases approved by the ACC." *See* Parcell Testimony, Attachment 9 at page 5. The fact that these "stable" outlooks specifically reflect the potential impact of the Company's interim filings undercuts the proposition that such outlooks conclusively demonstrate that "it is not imminent or probable that APS's debt will be downgraded to "junk" status if the $115 million interim rate increase is not granted." *See* Smith Testimony at 25.

Neither is there any merit to Staff's consultants' suggestion that a downgrade is not "imminent or probable" because credit rating agencies have not "announced that APS's debt would be downgraded if APS's request for interim rates were to be denied." *See* Smith Testimony at 25; Parcell Testimony at 12. As those experienced in the industry are well aware, credit rating agencies do not telegraph or otherwise expressly communicate to the utility or the public what specific impact a potential future event will have on that company's credit rating before the event occurs. A downgrade can happen in the blink of an eye, with no "announcement" or "warning" from the agency to the Company whatsoever. In fact, when S&P downgraded APS's debt from a "stable" BBB to BBB- in December of 2005, the Company did not learn that S&P had taken such action until I received a phone call from S&P's analyst an hour **after** the S&P ratings committee had already met and decided the issue.

Rather, what the Company has learned from the rating agencies – both through statements made in the reports cited above and from discussions with analysts – is that it is important that APS maintain an FFO/Debt ratio within **at least** the 18-20% range to stay within its current investment grade. For example, in conference calls that took place on July 22 and 25, 2008 between myself, APS's Senior Vice President and Chief Financial Officer, James Hatfield, APS's Vice President and Treasurer, Barbara Gomez, and Moody's personnel, Moody's specifically noted that APS's credit metrics needed to be in the upper part of the range applicable to APS and similar electric utilities because of what it believes to be Arizona's challenging regulatory environment. In a separate, in-person meeting between S&P representatives and Mr. Hatfield, Ms. Gomez, and me, held in S&P's San Francisco office on August 28, 2008, S&P expressly stated that it will be reevaluating the Company's credit status in its ratings committee after the Commission rules on APS's interim request. Together, these facts imply that if the Commission's decision in this matter deprives APS of the ability to keep its credit metrics within investment grade range, it faces the significant likelihood that APS's debt will be downgraded to junk status.

Neither does APS have any comfort in the fact that Moody's and Fitch currently rate APS two "notches" above junk grade, compared to S&P's one-level above junk credit rating, as Mr. Parcell suggests. *See* Parcell Testimony at 9, 17. As a practical matter, if any one of the three major credit rating agencies downgrades APS, the Company's debt will be regarded as junk by the market. Thus, if S&P downgrades APS to junk after taking the Company to its ratings committee following the resolution of this matter, APS and its customers will suffer essentially the same financial consequences that would have resulted had all three downgraded the Company's debt simultaneously. Moreover, any downgrade by one credit rating agency will likely cause others to reevaluate the Company's financial health and the reason for the downgrade under their own respective criteria, thus increasing the risk that more than one agency will revise the Company's ratings downward.

Q. PLEASE COMMENT ON STAFF'S CONCLUSION THAT THE VALUE LINE AND S&P STOCK EVALUATIONS CITED ON PAGE 14 OF MR. PARCELL'S TESTIMONY INDICATE THAT PINNACLE WEST'S "FINANCIAL STRENGTH AND VIABILITY" COMPARES FAVORABLY AGAINST OTHER ELECTRIC UTILITIES.

A. These services are fine for what they are, but their opinions simply cannot be used to support the point that Mr. Parcell attempts to make: that the Company's financial strength and viability are "below risk" compared to others in the **electric utility industry.**

Q. PLEASE ELABORATE.

A. Value Line and Standard & Poor's Equity Research each produce short reports on the stocks of **almost 2,000** companies of varying sizes and industries, not just those of the regulated electric utilities with whom Pinnacle West competes for equity investment. Value Line evaluates a universe of approximately 1,700 individual stocks, and each of its rankings is relative to all of the other stocks in Value Line's coverage universe, from small start-ups to Fortune 500 companies. Value Line determines its ratings by plugging historical data into computer models, with no independent research into the individual company at issue. Standard & Poor's Equity Research similarly ranks approximately 1,500 U.S. stocks, also using a computerized system. It stands to reason that, compared against a vast array of companies – many of which, because of their nature, experience tremendous daily and weekly fluctuations in stock value – regulated utilities with a relatively consistent revenue stream will generally rank well under such stock analyses as relatively stable investments. An electric utility is reasonably stable, for example, relative to a high tech company, a biotech company, or a recent Silicon Valley start-up IPO.

These rankings do not, however, reveal anything meaningful about the financial security of the individual company at issue, and thus cannot be used to suggest that APS is in a sound state of financial health or is not at risk of a ratings downgrade. Indeed, these stock evaluations are separate and distinct from credit rating analyses, a point made clear by Mr. Parcell's own exhibit, the S&P "Security Owner's Stock Guide" (attached to Mr. Parcell's testimony at Attachment 13), which notes that "[r]elative quality of bonds or other debt, that is, degrees of protection for principal and interest, called credit worthiness, cannot be applied to common stocks, and therefore rankings are not to be confused with bond quality ratings which are arrived at by a necessarily different approach." The stock evaluations on which Mr. Parcell relies thus cannot and do not support any intended implication that a credit rating agency will not downgrade APS because some stock analyst has classified Pinnacle West's stock as a "below average" risk relative to 1,700 other companies.

Neither, on their own, can these evaluations be used as "indicator[s] of financial strength and viability," as Mr. Parcell suggests. *See* Parcell Testimony at 14. In an attempt to support an overall conclusion that Pinnacle West is a "below risk electric utility holding company," Mr. Parcell cites three Value Line measurements – Safety, Beta, and Financial Strength – and one S&P Stock Ranking. *See* Parcell Testimony at 14-16. But as a close analysis of these rankings reveals, such a conclusion is simply inaccurate. I will take each listed ranking in turn.

According to Value Line, its "Safety" ranking is intended to measure, on a scale of one to five, the total risk of a company's stock relative to the approximately 1,700 other stocks in Value Line's coverage universe. As Mr. Parcell indicates, Pinnacle West's "Safety" ranking is a "2," not far from the 2.3 electric utility industry average. This ranking is determined by equally weighting two other rankings: Financial Strength and Price Stability. The Financial Strength rating, which Mr. Parcell separately identifies, attempts to evaluate and compare the relative financial strength of the broad range of companies whose stocks are reviewed by Value Line (using a "cash flow" analysis, though it provides little detail into its methodology). The relative ratings range from A++ (strongest) to C (weakest) in nine steps.

Although, as Mr. Parcell notes, APS is rated as an "A" in this regard – third of the nine levels – that rating is one that compares APS against a wide spectrum of industries, many of which have greater revenue and cash flow volatility compared to a regulated electric utility, and which thus may appropriately be deemed less financially strong for equity investment. The vast majority of the electric utilities in the Value Line investment survey fall closely together within the A to B+ range, with some few outliers scattered above and below. This measure thus shows little deviation between electric utilities and thus indicates little about how Pinnacle West's financial strength compares to that of its industry peers.

The second consideration in the "Safety" rating, the "Price Stability Factor" (which Mr. Parcell does **not** address), is intended to be "a relative ranking of the standard deviation of weekly percent change in the price of a stock over the past five years." The relatively high ranking of Pinnacle West and all other electric utilities in the Safety index is unsurprising given the emphasis on this factor. What the price stability analysis reflects is the fact that Pinnacle West's stock price has not varied significantly, **on a weekly basis**, over the past five years.

Stock values for regulated utilities seldom experience such short term price fluctuations, and would thus compare favorably against businesses in other industries that are at greater risk in this regard.

That is not to say, however, that Pinnacle West's stock has not fluctuated over the long-term. To the contrary: Pinnacle West's stock price per share has changed dramatically over the past several years, falling from a high of $51.67 on January 3, 2007 to a low of $30.26 on June 30, 2008 (below the book value per share of $37.22) – a 40% drop in stock price in just 18 months that equals a **$2.1 billion** loss of shareholder equity value and that has placed Pinnacle West's stock performance among the worst compared to others in the industry, as I have described.

As for the third Value Line category on which Mr. Parcell relies, "Beta," Value Line does not consider that category to be a "ranking" as much as a measure of stock volatility, attempting to capture how a particular stock price will move relative to the market as a whole. A stock with a beta of 1.0 is expected to move with the market over time. A stock with a beta greater than 1.0 is expected to rise or fall more than the market index. A stock with a beta lower than 1.0 is expected to be less volatile compared to the market index. There is thus little to be gleaned about Pinnacle West's "financial strength and viability" from Pinnacle West's Beta ranking of 0.80 compared to the electric utility industry average Beta of 0.87.

The last evaluation that Mr. Parcell cites is Standard & Poor's stock ranking of Pinnacle West as a "B+" – midrange on an eight point scale of A+ to D. This ranking, which attempts to capture the growth and stability of earnings and dividend record over the past 10 years, is almost certainly due to Pinnacle West's dividend per share growth and does not reflect APS's current "financial strength and viability," as Mr. Parcell erroneously suggests. As S&P explains, "[i]f a company pays a dividend on the common stock, it is highly unlikely that the rank will be below B-, even if it has incurred losses." *Standard & Poor's Quality Rankings: Portfolio Performance, Risk, and Fundamental Analysis*, October 2005, Standard & Poor's Corporation, c. 2005, p.5, found at http://www2.standardandpoors.com/spf/pdf/media/QualityRankingWhitePaperFinal.pdf.

As the Commission is aware, Pinnacle West restored its dividend at a low level in 1993 (after a three-year suspension) and grew it a modest $0.10 per share annually through 2006. As a result, its compound annual dividend growth rate from 1998 to 2007 was 5.8%. The average dividend growth rate for utilities that increased their dividends during that same time was 7.2%, demonstrating that these utilities increased their dividends by a greater margin than did Pinnacle West, even though starting from a higher base. When those utilities that did not increase their dividends are also considered, the dividend growth rate for the industry as a whole during this period was negative 0.2%. By the measure of dividend growth alone, Pinnacle West compares favorably to its industry peers. Indeed, given APS's massive underearning and its abysmal stock performance, Pinnacle West would have no chance of raising equity capital whatsoever, let alone on reasonable terms, if it terminated or reduced its dividends, nor would it have been ranked anywhere near a B+ under S&P's stock evaluation.

Given the narrow focus of S&P's rating of the Company's stock on dividend growth, such a ranking certainly cannot be used to suggest that the Company currently has sufficient financial strength to avoid the risk of credit downgrade during the course of the rate proceedings and the attendant inability to finance its necessary capital programs, nor can any of the other rankings to which Mr. Parcell refers. There is thus no merit to his conclusion that these evaluations show that APS's "financial strength and viability" compares well against others in the electric industry.

In fact, Mr. Parcell's conclusion is refuted by the following actual and undisputed facts: that, as a direct result of APS's poor financial health, Pinnacle West's stock is among the **worst performing** of all of the other investor-owned utilities with which Pinnacle West competes for equity capital, despite what any stock "risk" evaluation might be misread to suggest. As I noted in my Affidavit, APS's current financial condition has caused Pinnacle West's stock – which currently trades for below book value – to suffer a 19.5% drop in value during the three years ended April 30, 2008, while the electric utility industry as a whole experienced a 40.8% **increase** in stock value during this same period. *See* Brandt Affidavit at 8-9. Staff's consultants do not contest these facts, which put to rest any conclusion that Pinnacle West's stock is a "below average" risk for an electric utility or that APS's financial viability is somehow in better condition than the plain and undisputed evidence reveals. Their attempt to explain away these facts by focusing on stock evaluations that are virtually meaningless for the purpose of assessing the true state of APS's financial health is thus unpersuasive.

Q. HOW DO YOU RESPOND TO MR. SMITH'S SUGGESTION AT PAGES 21 TO 22 THAT INTERIM RELIEF IS NOT APPROPRIATE BECAUSE IT WILL NOT NECESSARILY PREVENT FUTURE DOWNGRADES OR CAUSE THE COMPANY'S DEBT TO BE UPGRADED?

A. I frankly do not understand Mr. Smith's suggestion that interim relief should be denied because it will not necessarily prevent a future downgrade. Essentially, Mr. Smith argues that APS should not be given the relief necessary to improve its credit metrics and provide it with an adequate buffer of protection against the risk of downgrade during the general rate proceedings because there may one day be an event of such magnitude that the Commission-provided buffer is insufficient and the Company is downgraded nevertheless. This is akin to arguing that a doctor should not treat a sick patient because that patient may be hit by a bus on the way home. While that may be true, it certainly should not be used as justification for failing to treat the patient to begin with.

As for the suggestion that interim relief should not be awarded because it will not result in a ratings upgrade, APS would welcome rate relief in a sufficient amount that its debt would be upgraded to higher credit levels. Indeed, that result is a key focus of the Company's plan for restoration of financial health, and would bring substantial benefits and long-term cost-savings to customers. But while interim relief is a necessary part of that plan – allowing APS to maintain current investment grade levels until its general rate case is resolved – the Company never intended for its interim request to result in a ratings upgrade. Nor is such a result required for interim relief to be appropriate. Just because the path to better financial health and higher credit ratings is slow and long, that does not mean the journey should not begin. The Company's interim rate request is an initial step in that journey.

D. Granting the Company's interim request will benefit customers and is in the public interest.

Q. MR. SMITH INDICATES THAT THE COMPANY HAS NOT SHOWN THAT THE INTERIM REQUEST WILL BENEFIT CUSTOMERS. PLEASE COMMENT.

A. I could not disagree more. The Company has shown that its current financial condition is such that it faces a serious risk of a downgrade to junk during the course of its general rate proceedings, and that – absent interim relief – it will be required either to bear the risk of a downgrade with no buffer to protect it against any added financial stress that may arise (with the attendant and undisputed ramifications on the Company and its customers, described in detail on page 13 of my Affidavit and conceded in Mr. Smith's testimony on pages 23-25 and Mr. Higgins's testimony on pages 3 to 4) or to forego projects that are either necessary for reliable service or that the Commission has otherwise deemed to be customer-beneficial and within the public interest. *See* Brandt Affidavit at 9, 13.

But even setting aside for a moment the substantial potential for downgrade, there is little question that the requested interim relief will improve the Company's earnings during the course of the general rate proceedings, which result itself will ultimately benefit customers. The belief that any action that inures to the benefit of shareholders must necessarily also be to the detriment of customers is simply wrong. The Company's ability to attract capital at reasonable prices such that it can provide reliable service and invest in customer-beneficial programs and sustainable technologies depends entirely upon its financial strength. The better APS's financial health, the lower the cost of capital that will ultimately be paid by customers to finance the projects from which they importantly benefit.

The converse is also true: the more the Commission artificially depresses electric prices in the short run, the worse the Company's financial health and the harder it will be for the Company to attract the capital it needs at reasonable prices. Equity capital invariably flows to where it can earn the best risk-adjusted returns, which means that the Company's *actual* rate of return is more important than its *allowed* rate of return. The better the Company's actual ROE, the better the terms on which the Company can issue equity. Because, as I have discussed, the Company's actual rate of return is significantly and negatively impacted by regulatory lag, any measure that reduces that impact and improves the Company's earnings will also improve the Company's chances of attracting needed capital at lower costs, thus keeping customer costs down in the long run. Because granting the Company's interim rate request will mitigate the impact of APS's extensive regulatory lag and improve the Company's ROE, it will also improve the Company's likelihood of being able to finance its necessary capital spending with a lower cost of capital, thus providing substantial benefits to customers.

IV. THE COMPANY'S PROPOSED AMOUNT OF INTERIM RELIEF WILL PROVIDE APS WITH A SUFFICIENT FINANCIAL CUSHION PENDING THE RESOLUTION OF THE GENERAL RATE CASE AND WILL BEST MEET IMPORTANT POLICY GOALS.

Q. HOW DID THE COMPANY CALCULATE ITS PROPOSED LEVEL OF INTERIM RELIEF?

A. The Company's proposed level of interim rate relief was not based on any analysis of what minimal level would be required to sustain the Company's credit ratings. Nor, contrary to Mr. Smith's suggestion, was it calculated in reference to the $1.7 billion that APS has expended in new facilities from the end of the Company's last Test Year through May, 2008 (a number that was mentioned only anecdotally in APS's Motion to illustrate the magnitude of the Company's capital spending obligations since its last Test Year). *See* Smith Testimony at 12. Rather, APS sought an interim base rate increase in the same amount of the roughly 4 mil 2007 PSA Adjustor that expired this past August in an effort to provide the Commission with the opportunity to implement the requested increase without any change in the amount of customer bills and to minimize rate volatility upon the conclusion of the Company's current general rate case.

Q. ASSUMING THAT THE COMMISSION FINDS THAT AN INTERIM RATE INCREASE IS WARRANTED, PLEASE EXPLAIN WHY THE $115 MILLION SOUGHT BY THE COMPANY IS AN APPROPRIATE AMOUNT.

A. Although the PSA Adjustor has now expired, the 4 mil figure remains an appropriate level of relief. Of the various amounts of relief suggested by the parties in this case, the Company's proposal provides the most reasonable level of protection for the Company against a ratings downgrade during the course of the general rate proceedings, generates an amount below what the Company is likely to receive under a conservative resolution of its general rate case and is thus not likely to require a refund. Also, if implemented in November of this year, the effective date of the increase can coincide with the rate **decrease** that most customers will experience in the November transition to winter rates, thus allowing the Commission to "phase-in" a significant portion of any increase resulting from the Company's general rate filing at a time when customers are likely to be impacted by it the least.

As an initial matter, there should be no dispute that some level of rate relief is appropriate to grant to APS at the conclusion of the general rate case. Both the AECC and Staff's consultants acknowledge in their Direct Testimonies that APS already has incurred legitimate capital costs that are not reflected in current rates, thus suggesting that the Company will receive some measure of rate relief when the permanent rate case is resolved. Even using what he refers to as a basic "non-controversial" analysis, Mr. Smith concludes that APS ultimately could demonstrate at least a $65 million increase in annualized revenue. The AECC proposes that an appropriate amount would be $42.4 million, effective January 1, 2009.

APS believes that a "non-controversial" analysis would actually support a much larger interim rate increase than the $115 million requested by the Company. In fact, as shown on Attachment DEB_RB-5, $115 million is not even in the upper range of the amount that justifiably could have been proposed.

I have summarized the analysis from Attachment DEB_RB-5 in the following table. Two adjustments to Mr. Smith's calculations are, at a minimum, necessary to fairly reflect the appropriate revenue requirement increase: the inclusion of book depreciation expense and consideration of the appropriate period. As to the former, Mr. Smith's revenue requirement analysis only considered a return "on" the "non-controversial" plant additions, and omitted the increased book depreciation that reflects the return "of" the investments in the revenue requirement. *See* Rebuttal Testimony of David Rumolo at pages 3-5.

Increased Revenue Requirements on ACC Jurisdictional Rate Base Growth

Period	Plant Additions	Plant Additions Including Rate Base Deductions	Revenue Requirement	Revenue Requirement On Increased Book Depreciation	Revenue Requirement Deficiency
	($M)	*($M)*	*($M)*	*($M)*	*($M)*
9/30/05 to 12/31/07	$1,114	$538	$65	$30	($95)
2008	$838	$401	$49	$23	($167)
2009	$907	$463	$56	$24	($247)

As this table shows, just including appropriate book depreciation on Mr. Smith's analysis results in a $95 million annual revenue requirement. But APS has made substantial ACC-jurisdictional investments since that time, and continues to do so. In 2008, it will have placed in service an additional **$838 million** of ACC-jurisdictional plant, bringing its cumulative annualized revenue requirement increase to **$167 million** using the same conservative analysis. By 2009, the same analysis on the additional projected **$907 million** dollars in gross ACC-jurisdictional plant additions brings the Company's annual revenue requirement increase to a cumulative total of **$247 million** – an amount that **more than doubles** the Company's requested $115 million level of relief. If the Commission finds it appropriate to use this type of non-controversial analysis as Mr. Smith suggests, APS would, of course, welcome any of the higher levels of relief that such an analysis can support. *See* also Rebuttal Testimony of David Rumolo at Attachment DJR_RB-1.

In addition to being a moderate request compared to what the Company might have otherwise proposed, of three alternatives presented by the parties, APS's proposal best provides the Company with a measure of protection from downgrade through the course of the general rate proceedings and meets the policy objectives described above. As I have previously explained, irrespective of any equity infusion by Pinnacle West[1], the Company's FFO/Debt ratio likely will fall below the 18% threshold of "junk" status in 2009, almost certainly before the Commission is able to reach a final decision in the pending general rate case – a fact of which rating agencies are acutely aware. Any interim relief granted should thus be sufficient in amount not just to keep APS teetering on the brink of junk, but to provide it with a level of protection against a ratings downgrade for as long as it takes for new rates in the general rate case to take effect. AECC Witness Kevin Higgins noted that "[i]n light of the cash flow pressures being experienced by APS, . . . some interim relief is warranted to protect retail customers from the negative consequences of a credit downgrade" and that "providing interim relief sufficient to allow APS to attain a 2009 FFO/Debt ratio of 18 percent, plus a reasonable buffer, during the pendency of its general rate case, is reasonable and in the public interest." *See* Higgins Testimony at 7.

While it is not possible to determine precisely what amount of rate relief will provide APS with a sufficient buffer to ensure the Company's ability to maintain its current financial metrics, continue to provide reliable service to customers, and prevent a ratings downgrade during the course of the general rate proceeding, the Company's proposal provides it with the most reasonable level of protection against such consequences. Under APS's proposal, the Company's FFO/Debt ratio would remain in investment grade through year-end 2009

[1] As discussed in Section V below, implementing the proposed $400 million equity infusion at the present time would not be in the Company's or the public's best interest and, in any event, would not minimize the need for the interim rate relief sought.

(19.6%), giving the Company a reasonable degree of cushion from downgrade until the FFO benefits from the general rate case decision can build (while still giving the Company some improvement in its ACC-jurisdictional earned rate of return on equity to 8.3% – still well below its currently allowed ROE of 10.75%), and phasing in a significant portion of the Company's general rate request at a time when customers are likely to be impacted by a rate increase the least.

Under the proposal of Staff's consultants, the Company's FFO/Debt is still just slightly above non-investment grade levels in 2009, at 18.7%, but falls again within junk range in 2010 at 17.8%. Similarly, AECC's proposed amount results in an FFO/Debt ratio of just 18.3% in 2009 and 17.4% in 2010. Though improved from the status quo, these credit metrics still leave APS teetering on the brink of junk throughout 2009 (and below that threshold in 2010) and thus do not provide the Company with virtually any layer of protection against any unanticipated event that may occur before new rates from the general rate case become effective. They also provide lower returns on equity compared to those generated by the Company's proposal, which makes it that much more difficult to attract new equity investors at reasonable terms. Moreover, because each of these amounts would naturally offset by a lesser amount whatever permanent rate increase is ultimately granted to the Company, these proposed alternatives do not as effectively address the policy benefits of most accurately reflecting the true cost of electric service on a current basis (thus sending appropriate price signals to customers) and phasing-in the impact of any final rate increase determined by the Commission in the general rate case.

Q. HOW DO YOU RESPOND TO MR. HIGGINS'S SUGGESTION THAT ANY INTERIM INCREASE SHOULD NOT TAKE EFFECT UNTIL JANUARY, 2009?

A. Delaying any rate increase until the start of 2009 would serve only to increase needlessly the risk of any negative action by the rating agencies and potential adverse impact of an unexpected event. Moreover, postponing the effective date of the interim increase beyond November of this year would deprive the Commission of the opportunity to implement the rate increase at the same time that most customers will experience a price decrease, thus moderating the financial impact of the interim relief on customers.

V. <u>TYING THE INTERIM RELIEF TO A REQUISITE EQUITY ISSUANCE IS CONTRARY TO THE PUBLIC INTEREST.</u>

Q. SHOULD ANY DECISION ON INTERIM RELIEF BE CONDITIONED, AS STAFF'S CONSULTANT HAS SUGGESTED, ON IMPLEMENTING THE PREVIOUSLY APPROVED $400 MILLION EQUITY INFUSION?

A. Absolutely not. Both practical and business implications make Mr. Smith's pre-condition unwise and counter-productive.

Q. WHAT ARE THE PRACTICAL IMPLICATIONS TO WHICH YOU REFER?

A. As an initial matter, it is highly unlikely that Pinnacle West would be able to issue equity by November 1, 2008, even in the event that it determined that it was appropriate to do so. Because of SEC disclosure rules that prevent an issuer from selling securities in the market when material news is pending, so called "blackout periods," (such as the announcement of quarterly earnings or the pending resolution of a significant regulatory matter), Pinnacle West is restricted from issuing stock from roughly October 10, 2008 until the release of the third quarter Report on Form 10-Q to the U.S. Securities and Exchange Commission in early November of this year, and then again in the early part of 2009. In addition, certain periods exist within the equity market when the ability to raise equity capital is virtually non-existent, including market holidays, anticipated significant Federal Reserve Bank actions, quarter-end and year-end periods, and the like. The upshot is that, between Pinnacle West's blackout periods and those where the market is inaccessible, it is unlikely that Pinnacle West would be able to issue equity and infuse it into APS before late March 2009 at the earliest. Postponing interim relief until that time further damages the Company's financial condition, makes a downgrade to junk all the more likely, and is thus against the public interest.

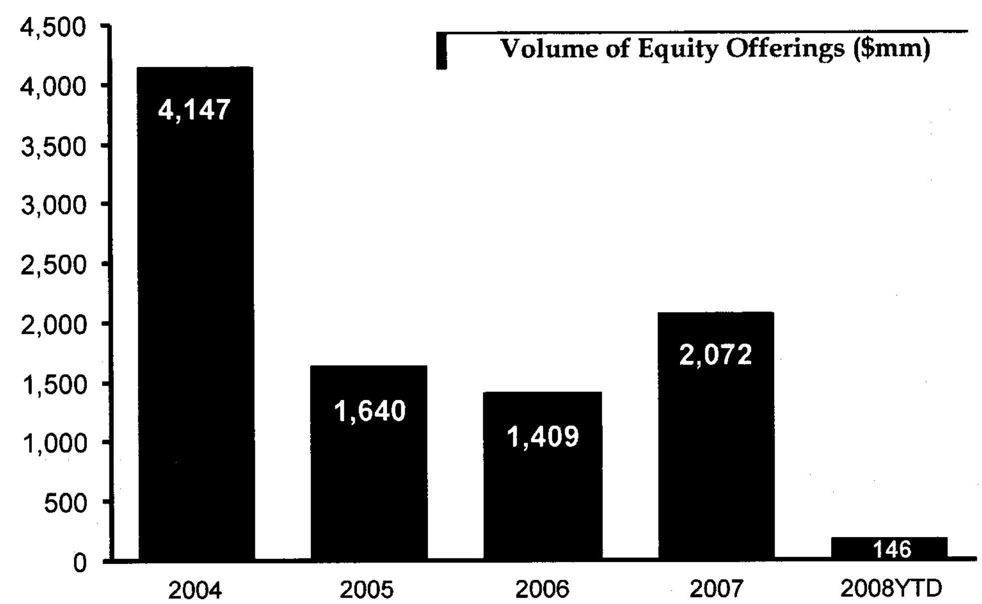
Q. WHAT ARE THE BUSINESS IMPLICATIONS TO WHICH YOU REFERRED?

A. A more significant reason why the grant of interim relief should not be conditioned on an equity infusion is that, between current market conditions and the Company's underperforming stock (which currently trades for below book value), attempting to issue equity before conditions improve would be foolish as a matter of both business practice and common sense. All companies, but in particular those in as precarious a financial condition as APS, must work to maintain an appropriate balance of equity, debt, and internal financing in light of then-existing market conditions. Given the unfavorable environment of current credit markets that are limiting financing options and the fact that the Company's stock price already is hovering at or below its book value, a condition requiring Pinnacle West to issue equity prior to or concurrent with the implementation of interim rates would be contrary to sound business and investment principles and would harm not only the Company's shareholders but its customers as well.

Q. DO YOU HAVE ANY EVIDENCE SUPPORTING YOUR CONTENTION THAT CURRENT MARKET CONDITIONS MAKE AN EQUITY ISSUANCE INAPPROPRIATE AT THIS TIME?

A. One needs only to review Wall Street Journal headlines over the past twelve months for evidence that the equity market is depressed and that all industries – not just electric utilities – are feeling the resulting impact. The specific impact of current market conditions on the willingness of electric utilities in particular to issue stock is well-exemplified by the following chart, which is based on the data provided to the Company by Merrill Lynch (one of the world's leading financial management and advisory firms) attached hereto at Attachment DEB_RB-6.

Integrated Utility Equity Issuance

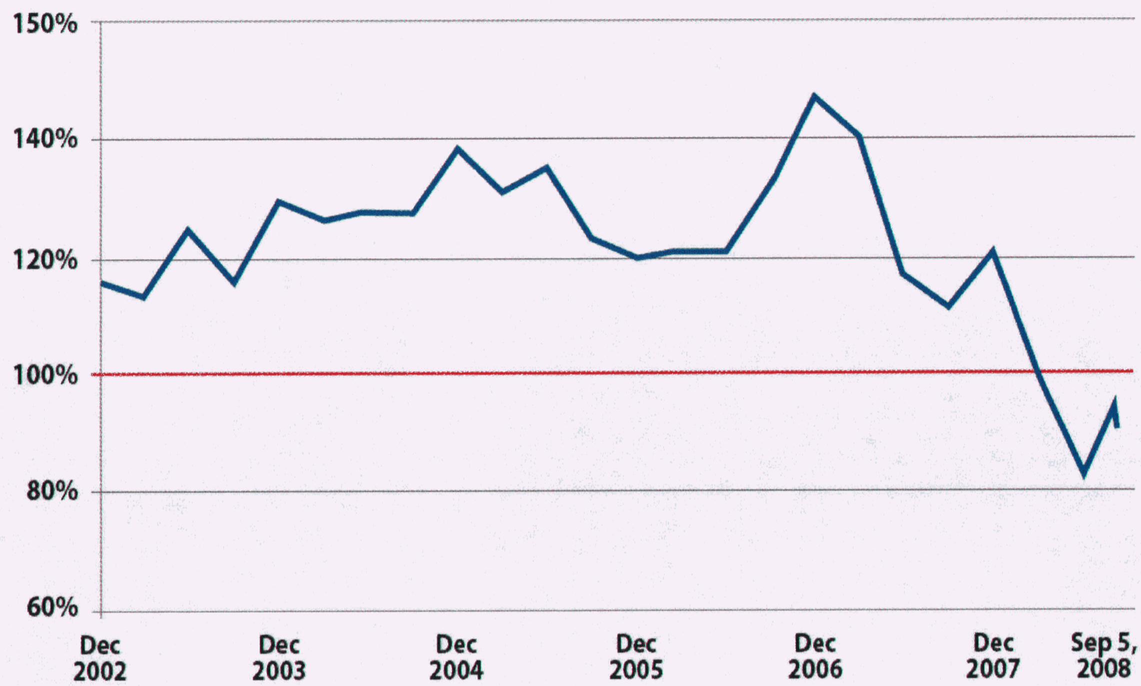


Source: Dealogic as of August 29, 2008. Includes utility and power equity & equity-linked offerings greater than $50 million in proceeds.

As this chart reveals, equity issuance transactions from integrated utilities have slowed considerably compared to what they were in 2004, and have all but stopped in 2008 (with only one such issuance being made to date this year). In 2004, the dollar volume of integrated utility equity offerings totaled $4.147 billion, falling to $1.64 billion in 2005, falling again to $1.409 billion in 2006, rising slightly to $2.072 billion in 2007 (an uptick resulting largely from a single, large offering of $615 million from Portland General Electric Company, resulting not from an ordinary equity issuance but from a sale out of the Enron bankruptcy), and then plummeting to just $146 million as of August 29, 2008. This data is compelling evidence that current market conditions have discouraged utilities nationwide from issuing equity in recent years.

For Pinnacle West in particular, any decision to issue equity in this volatile market would be especially detrimental in light of the fact that Pinnacle West's stock underperforms significantly compared both to the electric utilities against which it competes for equity capital, as I have previously discussed, and against its own past performance – an underperformance that is entirely attributable to the distressed financial condition of Pinnacle West's primary subsidiary, APS. In fact, as the following graph shows, Pinnacle West's stock is currently trading far below book value and has been for some months:

Pinnacle West Market-to-Book Value
December 31. 2002 – September 5. 2008



It is universally recognized that selling stock below book value means that a company is selling its shares for less than the value of those shares to existing shareholders, thus diluting the existing shareholders' investment and making it difficult to attract new investors. In addition, such an act sends a signal to the financial world that the Company does not believe its precarious financial condition will improve, thus further depreciating stock value and making the Company's ability to attract equity capital all but impossible. Moreover, because equity capital is more expensive than debt, and does not have a corresponding tax deduction, as does interest on debt, it increases the Company's overall cost of capital and is often the last tool in the toolbox to which the Company turns to meet its financing needs.

In the equity infusion docket, APS requested and was authorized to receive an equity infusion of "up to $400 million." The use of the words "up to" was an important caveat, because the Company intended to use only as much equity as was necessary and appropriate to strategically finance its capital program. Assuming the Company decided to issue the full $400 million (the amount that Mr. Smith would require here), the Company's future revenue requirement – and thus the future cost to customers – would increase by at least $40 million annually. Moreover, under current conditions, any equity issuance that Pinnacle West might be able to make would almost certainly be on unreasonable terms, thus increasing capital costs further. In the best of market conditions, newly issued common stock rarely sells for the last traded price before the sale, but is typically discounted in the range of 1% to 3%. Sales in a difficult market and under distressed circumstances result in discounts that are substantially greater. Equity issuances are one of the most important matters that companies and boards of directors face, and, as CEO of APS, I could not reasonably recommend to our Board of Directors that we make an equity offering under such conditions.

Staff's consultant's condition also assumes that Pinnacle West would be able to issue equity at all in the near term, which may not be possible – a point recently underscored by Daniel Ford of Lehman Brothers Equity Research, the preeminent Wall Street electric utility analyst, who, in commenting on Staff's filed testimony in this matter, noted that "[w]e view the $400 million equity infusion as difficult to meet given the current environment for equities, and specifically given that PNW's equity is currently trading below book value."

See Lehman Brothers Equity Research Company Update on Pinnacle West Capital, September 2, 2008, attached hereto at Attachment DEB_RB-7.

Equity issuances can be a necessary and beneficial form of financing, and the Company should continue to be allowed the flexibility to use them as strategically appropriate. Nevertheless, it is hardly within the public interest to pre-condition otherwise necessary interim relief on such issuances if the associated costs can be avoided. To whatever extent the Commission and the Company can bolster APS's financial health without forcing Pinnacle West to issue equity under current market conditions, good business practice and public policy strongly suggests they should do so. This is particularly true in light of the fact that the data and analysis supporting the Company's request for interim relief already assume and incorporate any benefit from such infusion, and thus the additional equity would not alleviate the pressing need for immediate assistance from the Commission.

Q. MR. SMITH APPEARS TO SUGGEST ON PAGE 40 OF HIS TESTIMONY THAT, IN APPROVING THE COMPANY'S EQUITY INFUSION APPLICATION, THE COMMISSION SOMEHOW REQUIRED THE EQUITY INFUSION TO OCCUR. HOW DO YOU RESPOND?

A. That Decision simply granted Pinnacle West the authority to issue equity and infuse it into APS in the event that Pinnacle West "determines that it would be strategically advantageous to do so." *See* Pinnacle West's Notice of Reorganization in Docket No. E-01345A-08-0228. *Cf.* Decision No. 70454 at Pages 3-4 (finding as fact that its authorization would allow APS to issue equity capital "in recognition of the broader economic conditions" and incorporating in its first ordering paragraph all of the terms "set forth in the application.")

In granting the Company's request, the Commission considered and approved an amendment to the application that extended the authorization through December 31, 2009. *Id.* As the discussion at the open meeting in that matter made clear, the Commission approved that amendment in order to give Pinnacle West the flexibility it needed to issue equity when the timing was right, consistent with sound business practice and in light of the Company's underperforming stock value and depressed market conditions. Mr. Smith's attempt to use that approval now as a means to require the Company to issue equity before market conditions improve and Pinnacle West determines that the timing is appropriate undermines the very flexibility that the Commission found desirable in granting that authorization and must therefore be rejected.

Although the Company believes that it was and still is critical to preserve its ability to issue additional equity, it is clear that actually issuing such equity at this time would only exacerbate the Company's delicate financial condition and would weaken the Company's financial structure in the long-term. There simply is no valid reason to tie the propriety of interim rate relief to an action that will not impact the required amount of such relief or otherwise benefit the Company or its customers. Just as the Company must continually evaluate its current circumstances to determine the necessary level of capital expenditures and best financing options, so too should the Commission consider all pertinent factors in deciding how the Company may best address its needs. Mr. Smith's recommendation does not do so.

VI. CONCLUSION

Q. DO YOU HAVE ANY CONCLUDING REMARKS TO YOUR REBUTTAL TESTIMONY?

A. Yes. APS envisions a bright and innovative energy future for Arizona – one in which APS not only continues to do its job of supplying reliable electric service for the State's growing demand, but that also fosters a sustainable environment and reflects the benefits of high quality customer service and investment in new customer-friendly and energy-efficient technologies. APS hopes and believes that the Commission shares these important goals.

But the Company's ability to make these investments and sustain reliable customer service depends entirely upon APS's financial strength, which in turn requires timely and supportive regulatory treatment. Today, Arizona's extensive period of regulatory lag, coupled with the Company's extraordinary spending requirements, has had a destructive impact on APS's financial condition and has substantially increased the risk that APS's credit rating will be downgraded to junk – a risk that Staff and RUCO both understate and under-appreciate, with potentially devastating (and undisputed) consequences.

These are the very types of "special circumstances" that justify the granting of interim relief. Neither the Company nor the Commission should allow the view of what is "normal" or "traditional" to stand in the way of equipping APS with the means to provide reliable service to its more than one million customers and to implement progressive and innovative energy policies that are imperative to the sustainability of our State's energy future.

Q. DOES THAT CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes.

UTILITY FOCUS

March 14, 2008

PINNACLE WEST CAPITAL (PNW)

Overview

PNW's principal subsidiary Arizona Public Service (APS) is one of the fastest growing electric utilities in the U.S. APS' customer growth in 2007 was 3.3%, and averaged about 4% during the years 2005 through 2007. In mid-2007, APS received a decision from the Arizona Corporation Commission (ACC) in a long-standing electric rate case that contained several positive aspects. However, the proceeding was decided about 20 months after the case was filed -- we note that the extent and consistency of the exorbitant regulatory lag in Arizona is without comparison in the industry. APS is expected to file a new base rate case within the next few weeks -- we believe that such a proceeding would not be decided until at least the fall of 2009. The upfront costs associated with customer growth, combined with the length of time it takes to complete a general rate case in Arizona, is clearly a source of long-term earnings attrition. PNW's earnings from continuing operations have fallen in each of the last two years and the company has earned a single-digit return on equity since 2003.

In addition to APS, which accounted for about 92% of consolidated income in calendar 2007, PNW's businesses include real estate development conducted by subsidiary SunCor (4% of consolidated income) and marketing and trading operations and energy-related investments (about 4%). PNW did not raise its dividend in 2007, thus ending its streak of dividend increases at 13 straight years. In terms of stock price performance relative to the industry, the PNW shares underperformed significantly in 2007, falling 16% versus a roughly 10% average stock price for companies in the RRA Index. This underperformance has continued into 2008; year-to-date, the PNW share price has fallen about 18%, compared to 11% drop in our index.

Regulated Operations

Arizona's electric industry is considered to be restructured, given that retail access is permitted; however, there are no competitive retail suppliers in the state, and the ACC continues to regulate the utilities' in-house generation under a traditional rate-of-return/rate base regime. APS' most recent case was decided in June 2007 – the ACC granted the company a $322 million (15%) rate increase, effective July 1, 2007, based upon an

Pricing Informtaion	
Closing Price	$34.95
Date of Closing Price	03/13/08
Shares Outstanding (Shares)	100,499,104
Outstanding as of:	02/21/08
Market Capitalization ($M)	3,512.44
Total Enterprise Value ($M)	7,087.70
Market/Book	99%
Return on Equity	8.60%

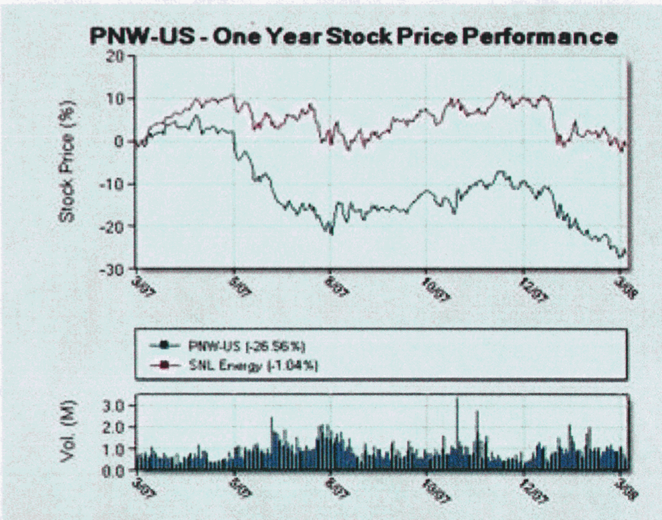
Credit Ratings	
S&P Senior Unsecured Rating	BBB-
S&P Senior Unsecured Date	06/28/2007
Moody's Senior Unsecured Rating	Baa2
Moody's Senior Unsecured Date	04/27/2006
Fitch Senior Unsecured Rating	BBB-
Fitch Senior Unsecured Date	12/21/2007

Year	* EPS	P/E Ratios
2006	$3.10	--
2007	$2.98	11.7x
2008E	$2.65	13.1x
2009E	$2.70	12.9x

	Dividend	
Rate	Yield	Payout
$2.10	6.04%	71%

* EPS Adjustments shown on last page.

* Senior unsecured ratings of Arizona Public service co is shown since the ratings for the holding company are not available.



above-industry-average 10.75% ROE and a $4.4 billion original-cost rate base. While this was a relatively significant rate hike in percentage terms, we note that the case was based upon a very stale test year (12 months ended Sept 30, 2005) that concluded almost two years prior to the date of decision. This, as well as some of the restrictive adjustments adopted by the ACC, has made it difficult for APS to earn the ROE authorized in the case.

Positive aspects of the ACC's rate decision included the authorization of a significant interim power cost rate increase on May 2, 2006. This increase was supposed to be in effect until year-end 2006, but the Commission ultimately extended the emergency increase beyond that date when it became evident that the case was not going to be decided by that time. Additionally, the ACC removed the lion's share of the restrictive limitations that had been placed on APS power supply adjustor (PSA) in the company's previous rate proceeding. Specifically, the Commission: removed the $776.2 million total PSA recovery cap; eliminated the 4-mil "lifetime" on the annual PSA adjustor, replacing it with a 4-mil "annual" cap; added a "forward" component to the adjustor; and, eliminated the requirement that a PSA surcharge application be filed whenever the deferral balance reached $100 million. However, the ACC retained the 90/10 sharing mechanism, whereby the company absorbs 10% of fuel and purchased power costs that are in excess of the amount reflected in base rates.

Another issue that was considered in the rate case pertained to the costs incurred during the 2005 Palo Verde outages. The ACC disallowed costs of about $14 million, including accrued interest ($8 million net-of-tax), and approved the recovery of the balance (roughly $34 million, including accrued interest) through a temporary PSA surcharge over the 12 months through June 30, 2008. This increase was in addition to the base rate hike noted above.

More recently, on Feb. 13, 2008, the ACC ordered APS to account for residential line-extension fees as contribution-in-aid-of-construction (CIAC) rather than revenue. We believe that the Commission intends to revisit this issue in the future, most likely in the context of APS' next rate case. This issue relates to a new tariff for "growth" customers who require a line extension for newly constructed homes. Prior to this ruling, such customers were granted a "free footage" line extension allowance. The ACC approved APS' proposal to charge line-extension customers a fee equal to the total estimated construction costs; however, the Commission denied the company's proposal that the new tariff be classified as revenue that can be used as a dollar-for-dollar offset to mitigate future rate increases for all other customers, and instead ordered the fees to be classified as CIAC. The company had indicated that its proposed treatment was consistent with the ACC's contention that growth customers should pay at least a portion of the higher costs that would otherwise be imposed on all APS customers. Accounting for these fees as CIAC will provide an increase in cash flow, but will have no impact on revenue. In APS' next rate case, the CIAC will be used to reduce rate base, thus offering only a limited downward effect on all other customer rates.

Additionally on Feb. 13, the ACC approved APS' request to implement a $30 million increase, subject to refund effective March 1, through a transmission cost adjustor. The increase was equal to that approved by the Federal Energy Regulatory Commission (FERC), also subject to refund, pending the FERC's final decision in an APS transmission rate case. It is our understanding that settlement discussions are ongoing in the FERC proceeding. We note that the FERC approved APS' request to implement a $37 million transmission rate increase, subject to refund, with $30 million allocated to the Arizona jurisdiction and $7 million to wholesale transactions. The $37 million increase is based upon an 11.3% ROE and a calendar-2006 test year.

As previously noted, APS is expected to file a new rate case in the very near future. Assuming that the ACC adheres to its unfavorable practice of deciding rate cases within a 15-20 month time frame, this next proceeding would be decided in the fall of 2009. We note that late 2009 appears to be a period that will be free of gubernatorial or commissioner elections, factors that can delay or negatively affect the outcome of a major rate proceeding. By that time, the ACC will have three new members, as Chairman Mike Gleason and Commissioners William Mundell and Jeff Hatch-Miller, all Republicans, are term-limited and cannot run for re-election. Elections for these four-year terms will take place in November 2008. The other two commissioners, Kristin Mayes and Gary Pierce are serving terms that extend to January 2011.

Earnings and Finances

PNW's per share earnings from continuing operations in 2007 were $2.98 versus $3.10 in 2006. EPS were negatively impacted by: a slowdown in sales of homes and land at Suncor due to conditions in the western U.S. real estate market, $(0.37); higher generation operations and maintenance expenses, including overhauls and a Palo Verde performance improvement plan, $(0.26); and, higher depreciation and interest associated with increased capitalized plant balances, $(0.17). These negatives were partially offset by: retail sales growth, $0.28; favorable weather, $0.23; and, the impact of the mid-year rate increase decision, $0.13.

For 2008, our $2.55 EPS estimate is within the guidance range provided by the company, and reflects the following earnings-reducing factors: normal weather; the absence of a 2007 prior-period tax adjustment; the mid-2008 expiration of a power sales contract; slightly lower income from Suncor; and, increased O&M, depreciation, taxes, etc., associated with service territory growth. These factors are to be partially offset by the full-year effect of the 2007 ACC rate decision; the March 1, 2008 implementation of increased transmission rates; and, continued customer growth, albeit at a lower rate (APS forecasts customer and sales growth to approximate 1-2% during the years 2008 through 2010).

PNW's capital expenditures for the years 2008 through 2010 are estimated at about $3.74 billion, spread fairly evenly over the period. More than one-half of this amount is targeted for APS delivery operations (infrastructure additions, upgrades, and replacements, new customer construction and related information systems), and about 30% targeted for generation (primarily additions, upgrades, and replacements of various plant equipment -- turbines, boilers, and environmental equipment). Most of the remaining cap ex is related to investments at SunCor. The lion's share of the forecasted cap ex is expected to be financed internally; however, the company expects to issue both debt and equity during the year. PNW last issued common stock in 2005, and at year-end 2007 its equity ratio approximated 49%. Currently, APS' senior unsecured bonds are rated BBB- by Standard & Poor's, Baa2 by Moody's, and BBB by Fitch.

We note that in 2006, the ACC increased the state's renewable resource requirements, whereby the utilities will be required to supply 15% of retail energy sold from renewables by 2025. The ACC also required distributed generation to comprise 5% of the renewables portfolio beginning in 2007, with this percentage to increase to 30% by 2012. In connection with these standards, in February 2008, APS entered into a 30-year contract to purchase the energy and related emissions credits from a 280-MW solar power plant that is expected to go into commercial operation in 2011. The completion of this plant, by Abengoa, a Spanish company, is dependent upon the extension of certain federal tax credits.

RRA Evaluation: While Arizona's regulatory climate has improved somewhat over the past few years from the standpoint of more constructive treatment of rate case issues, the rate case process continues to be unnecessarily laborious and contentious, and politically driven. It took the ACC a total of almost four years to decide the last two APS rate cases – certainly not optimum conditions for a high-growth utility to operate under. Additionally, regulators have not given any indication that the next rate case for APS will be decided in a shorter time frame. Cash flow has improved with the relative stabilization of fuel prices, the operation of the PSA, and the mid-2007 rate case decision. PNW's unrecovered fuel and purchased power deferral balance has declined; at year-end 2007, the balance was $111 million, down from $160 million at year-end 2006. Given its stagnant earnings trend, PNW did not raise its dividend in 2007 after 13 straight years of increases, and its stock performance over the past several months has resulted in a dividend yield that is one of the highest in the RRA Index. On the basis of our estimate for 2008, PNW is trading at a small discount to the group, a level we view as appropriate given the regulatory issues that this company continues to face. We are continuing our "Hold" recommendation on the PNW shares. (Previous Report: 6/8/07)

Robert Schain

FEDERAL ENERGY
REGULATORY COMMISSION

NEWS

June 19, 2008

NEWS MEDIA CONTACT
Mary O'Driscoll - 202.502.8680

FERC Examines Causes of, Responses to Rising Electricity Costs

Higher fuel prices, increased capital costs and continued uncertainty about climate policy are helping fuel the rising costs of electricity faced by consumers across the country, the Federal Energy Regulatory Commission (FERC) said today.

The rising cost trends are likely to continue for years, according to a report presented to the Commission by analysts from FERC's Office of Enforcement. The report pegs current futures prices for natural gas at $2.50 to $5 above the average 2007 spot price for natural gas, and costs for everything from iron and steel to cement and copper wire rising significantly over the past several years. Those have contributed to increases in the cost of new generation for every type of power plant, from nuclear power to combustion turbine and wind generators.

"FERC regulatory policy must be based on reality, and that sobering reality is that the upward pressure on electricity prices – higher capital costs for new power plants, higher construction costs, and higher fuel costs – should continue for some time," FERC Chairman Joseph T. Kelliher said. "That means electricity prices will be higher than many Americans would like."

"We must confront three realities: FERC is regulating in a high-cost environment; the United States needs massive investments in new electricity generation, transmission and distribution facilities; and we are beginning to confront the climate change challenge, which puts us in a period of uncertainty regarding policy," Kelliher added. "There is tension among these three realities, and they work at cross purposes. The United States cannot simultaneously make the massive investments necessary to assure security of our electricity supply, make additional large investments to confront climate change, and lower electricity prices. Doing so would likely result in failure."

The report says that consumers and the market likely will respond with demand response measures that help reduce energy consumption during times of peak prices, energy efficiency and conservation measures, and technological innovations that could usher in changes that help reduce costs and improve value, as they did in other competitive industries such as telecommunications.

The FERC staff report, "Increasing Costs in Electric Markets," is available on the FERC website, www.ferc.gov.

(30)

R-08-43

FEDERAL ENERGY
REGULATORY COMMISSION

STATEMENT

June 19, 2008
Item Nos. A-3

Chairman Joseph T. Kelliher

Statement of
Chairman Joseph T. Kelliher
on
Cost of Electric Generation Staff Presentation

"I thank the staff for the presentation, which highlights some of the hard realities that FERC is confronting, and that are guiding the development of FERC regulatory policy. I think it is important that these hard realities be better understood by the general public and others.

FERC regulatory policy must be based on reality. The reality is that upward pressure on electricity prices – higher capital costs for new power plants, higher construction costs, and higher fuel costs – will continue for some time. That means electricity prices will be higher than many Americans would like.

We are actually confronting three realities. First, FERC and state commissions are regulating in a high-cost environment – that is not likely to change soon. Second, the U.S. needs massive investments in new electricity generation, transmission, and distribution. Third, we are beginning to confront climate change challenge, and are in period of uncertainty regarding policy. Acting on climate change will come at a significant cost – not necessarily an unreasonable cost.

There is tension among these three realities – they work at cross purposes. FERC has regulatory policies designed to encourage investments in generation and transmission. These policies have been criticized because they have some impact on cost. New coal generation has been cancelled due to climate change uncertainty, reflecting the tension between security of electricity supply and climate change.

We must accept the U.S. cannot make the massive investments necessary to assure security of our electricity supply, make additional large investments to confront climate change, and lower electricity prices at the same time. If we try to do all three, the result will likely be failure.

What can we do about price? We cannot change cost fundamentals, either for power plant costs or fuel costs. Coal prices and the costs of construction materials are set in a world market. Natural gas prices are still set on regional basis, reflecting North American market fundamentals.

The U.S. can improve energy efficiency and demand response, and FERC is acting in these areas, benefiting from the leadership of Commissioner Wellinghoff.

We can make sure that when power plants are built, they are built in a way where competitive pressures govern cost both construction cost and operating costs. There is more than one path to support new generation, and some paths more likely than others to produce lower cost electricity.

We can make sure prices are not a product of market manipulation or market power exercise. FERC's duty is to assure that wholesale electricity prices are just and reasonable. That means prices that are high enough to support continued investment in new electricity supply, environmental mitigation, and improved delivery across transmission and distribution lines.

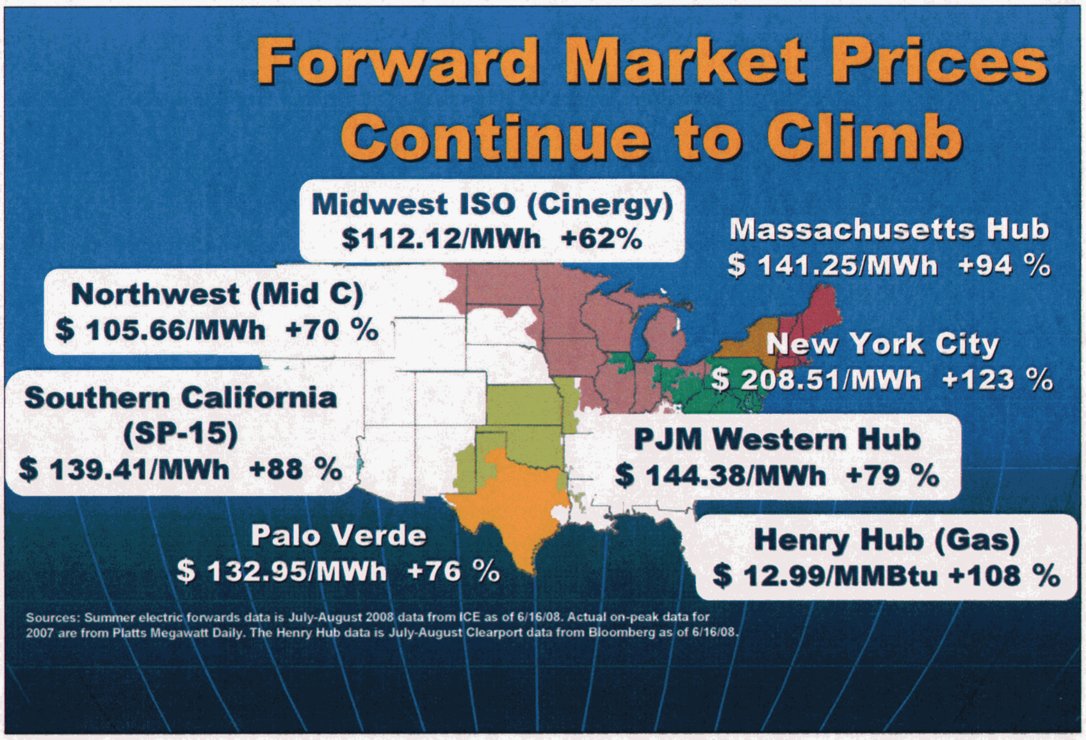
We recognize the risks of market manipulation may be greater in a high-cost environment, and we will remain vigilant to assure the wholesale prices reflect market fundamentals, rather than manipulation. We can assure wholesale power prices do not rise any higher than they have to in order to assure security of our electricity supply and meet the climate change challenge.

The last time we were in a high-cost environment similar to this was the late 1970s and early 1980s. Back then, the high-cost environment was the product of traditional rate regulation. Competition policy was created as a direct response to the failure of regulation.

Competition policy was rooted in the conviction that competition does a better job controlling costs than regulation, that competition does a better job developing and deploying new technologies, that competition does a better job improving operating performance, and competition properly shifts risk from consumer to market participants. Those truths still apply today, and competition policy is best suited to address the hard realities we are confronting today."

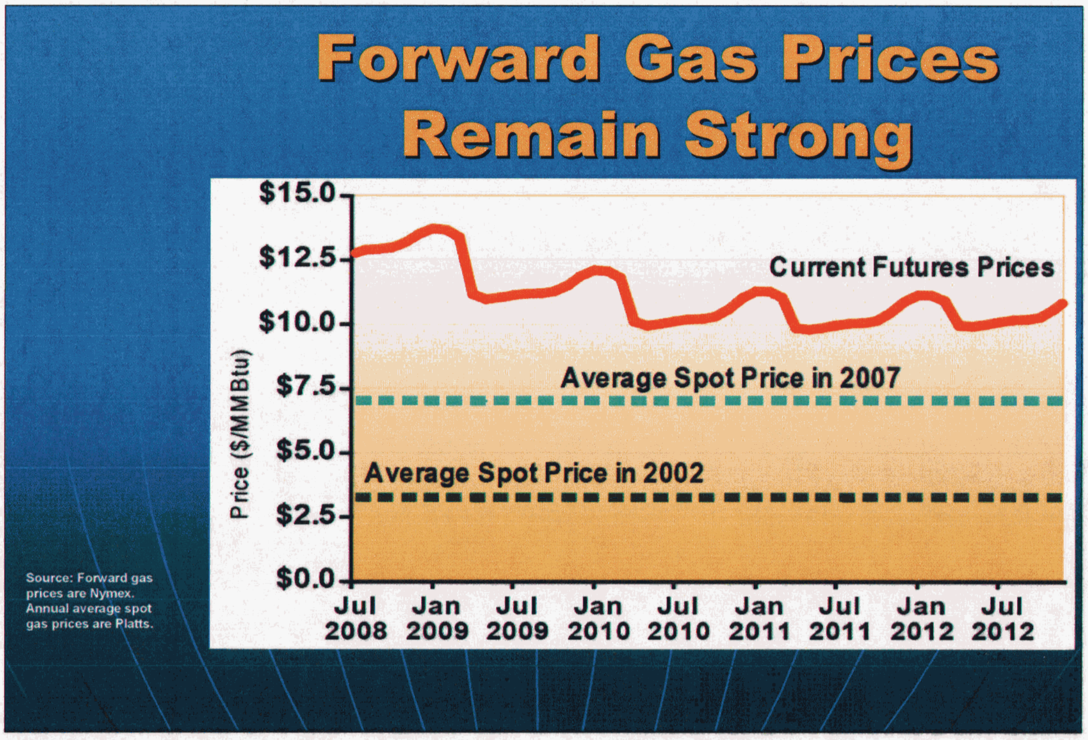
Item No.: A-3
June 19, 2008

Mr. Chairman and Commissioners, good morning. I am here to present the Office of Enforcement's assessment of likely electricity costs in coming years. This presentation will be posted on the Commission's Web site today.

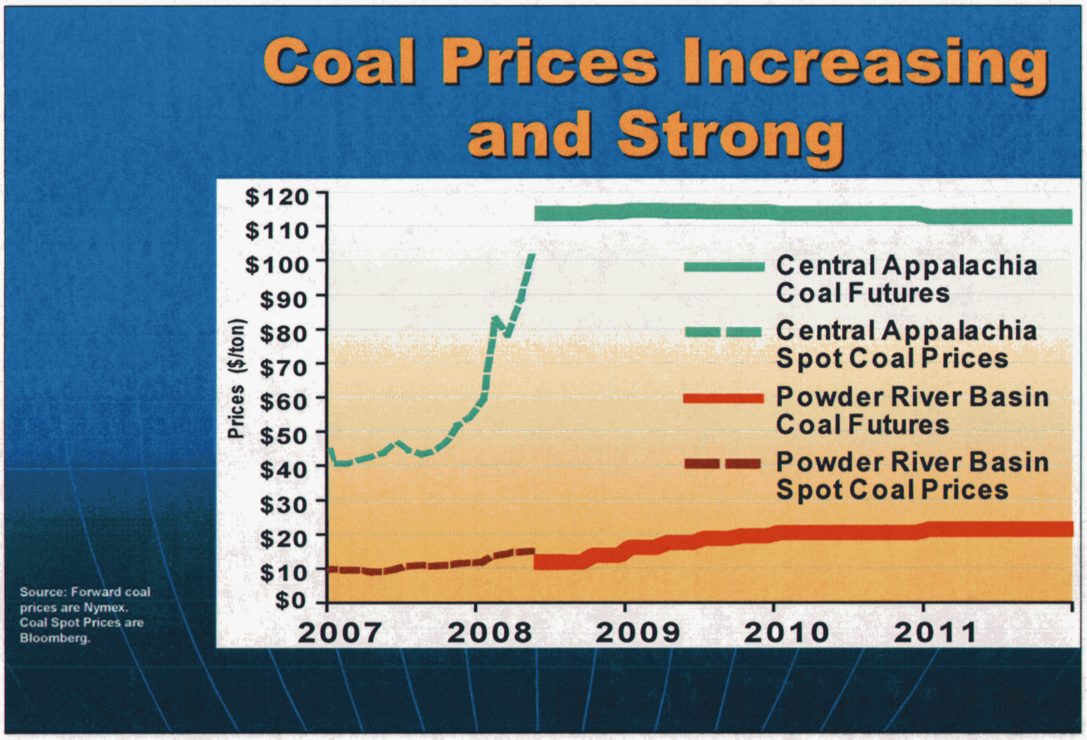


At last month's meeting, we reported that forward market prices for electric power are much higher than the prices we actually experienced last year. This trend is universal around the country. The slide shows the increases in forward prices for July and August as of this week. They have risen further during the last month as natural gas prices have continued to rise.

There is little reason to believe that this summer is unusual. Rather, it may be the beginning of significantly higher power prices that will last for years. The purpose of this presentation is to explain why that is so. The two major factors pushing the costs of electric generation higher are increased fuel costs and increased cost for new construction. These factors affect all parts of the country. That is, higher future prices are likely to affect all regions.



The primary reason for the electric power price increases this year is high fuel prices. All current market indications suggest that they will remain high. Let's look at natural gas, which often determines prices because it is so frequently on the margin. The slide shows futures prices for the next few years. The futures prices are somewhat lower for 2009 than for 2008. Even so, they are a good deal higher for all years than the prices people actually paid last year, and they are much higher than the prices many of us remember from earlier in the decade. The implication is that markets anticipate continuing high prices, even though they know that the United States has seen a significant increase in domestic natural gas production over the last year and a half. The anticipation of further high prices makes more sense when one considers the likely increase in gas demand for generation and the global nature of competition for LNG.



Natural gas is not the only important fuel in setting electric power prices. Coal still powers half of all power produced in the U.S. In some markets – the Midwest and the Southeast, for example – coal is often on the margin and plays a major role in setting average prices over time. The slide shows that the price of one key form of coal – Central Appalachian coal - has risen rapidly over the last year. Forward markets show continuing high prices for Central Appalachian coal for the next three years. This reflects, in part, the growing global market for coal and the relatively weak US dollar. Coal imports are becoming more costly and coal exports more profitable, both of which contribute to higher prices in the United States.

I should mention that other coal prices behave somewhat differently from Central Appalachian coal. For example, a majority of the overall cost for Powder River Basin coal comes from transportation rates and can be more difficult to see. Nonetheless, the implication of the prices we can see is that electric power prices are likely to increase even where coal is on the margin. This may take place somewhat differently from the way natural gas price increases flow through into power prices. Generally, companies buy coal under fairly long term contracts, so there may be a lag before the higher prices show their full effects. But the effects are coming.

Net Natural Gas Generation by Region

(TWh)

Region	2000	2007	Difference
Northeast	66.3	103.9	37.6
RFC	41.0	64.5	23.5
SERC	86.9	150.5	63.6
FRCC	42.0	96.7	54.7
ERCOT	155.9	163.3	7.4
Midwest	44.2	62.8	18.5
WECC-Rockies and SW	28.1	77.6	49.5
WECC-CA and NW	115.4	129.7	14.4

Source: Derived from Energy Velocity (differences due to rounding).

While both natural gas and coal prices have increased rapidly, natural gas is increasingly important in every region of the country. The slide shows that even in regions where coal has historically dominated – most noticeably in SERC– natural gas usage has grown substantially since 2000, up 63.6 TWh in 2007, more than in any other region. Noticeable increases also occurred in FRCC, which has flexibility to burn either gas or oil at many facilities, and also in the Rockies and Southwest where demand continues to grow considerably.

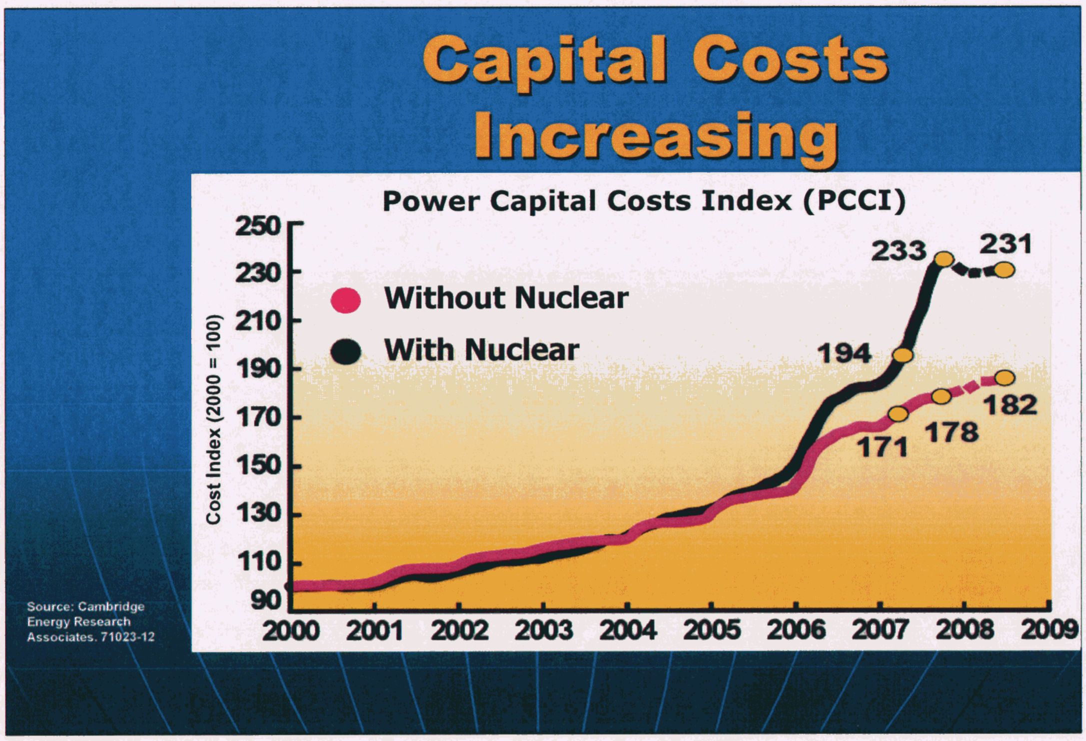
NERC Net Load Projections through 2016

Region	Total Difference (GW)	Percent Change
Northeast	9.7	17
RFC	23.2	13
SERC	28.2	14
FRCC	7.1	15
ERCOT	14.7	24
Midwest	17.2	21
WECC-Rockies and SW	7.6	25
WECC-CA and NW	10.9	10
Total	108.8	14

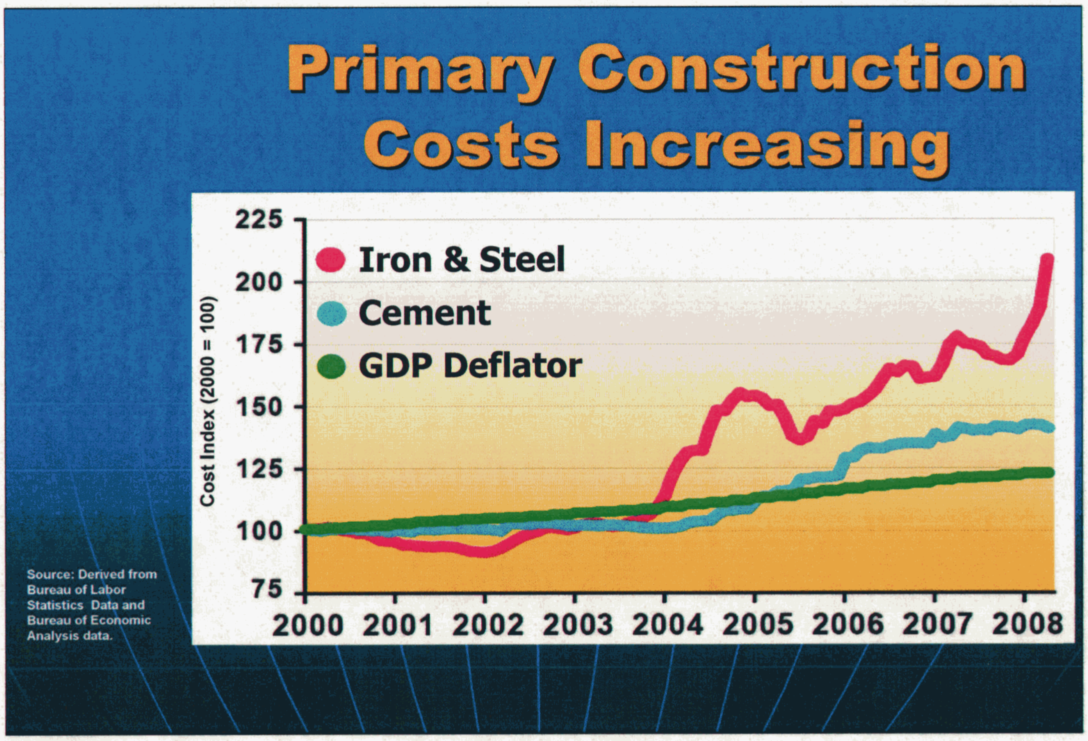
Source: Derived from NERC 2007 Long Term Reliability Assessment, Oct. 2007 and NERC data request, June 2008.

The second major factor that will put upward pressure on electric power prices is the increasing cost of new construction. This effect is particularly important because the country is entering a period when we will need to make substantial new investments, especially in generation.

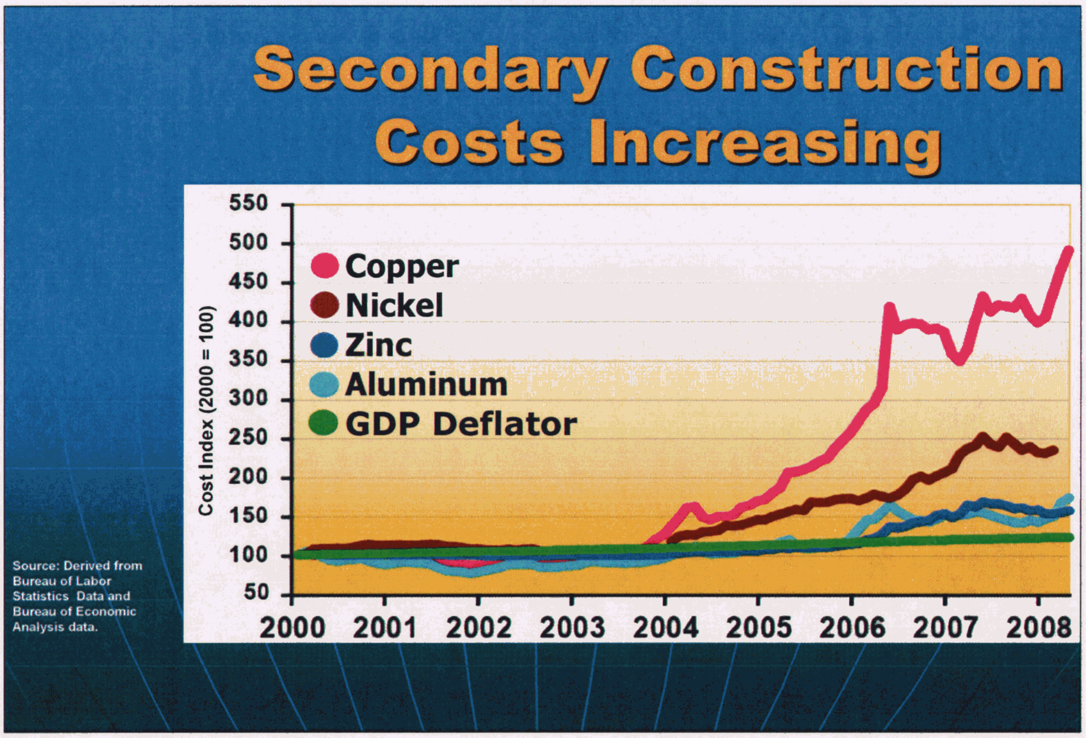
Natural gas fueled most of the last great wave of generation investment, which occurred between 1995 and 2004. In recent years, demand in most regions has gradually caught up with the capacity built around 2000. Looking forward, demand will continue to grow, and the need for new capacity will become ever more acute and ever more widespread. The slide shows NERC's expectation of peak net load growth in different regions for the next 10 years. We at the Commission are not in the business of forecasting, so I would just say this: There are legitimate reasons to be unsure about exactly how much new generation the country will need in the coming years. For one thing, higher prices will themselves discourage some power demand. Nonetheless, a significant level of demand increase seems virtually inevitable. So will be the need to build more capacity.



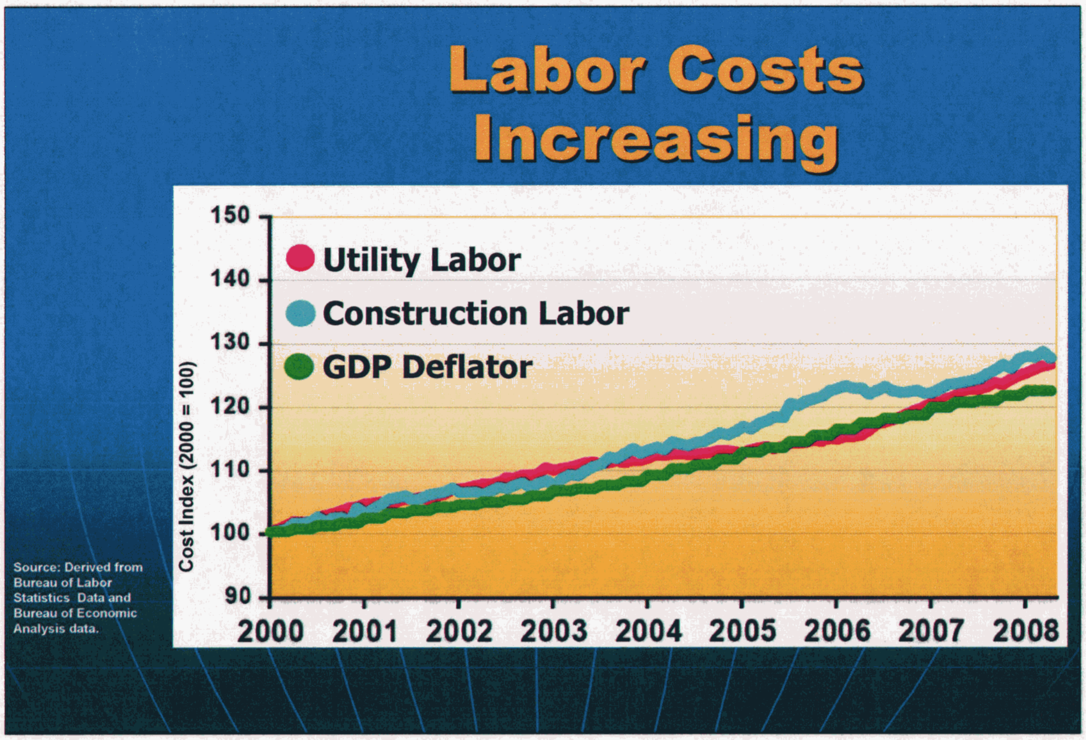
The need for new generation is important because new construction is becoming more expensive – quite aside from fuel price increases. Cambridge Energy Research Associates – CERA – produces an index of costs for the main inputs that go into building new generating plants. The slide shows how that index has almost doubled since 2003. The increase in nuclear plant inputs has risen even faster. Much of this cost increase results from rising global demand for basic materials. Part of it also comes from shortages of people to do key engineering and construction jobs. In any case, the implication is that, we will pay more, not less, for the next round of construction.



Let's look at some of the reasons that CERA's index is rising so rapidly. The slide shows two of the primary construction materials for electric generating plants – concrete is on the blue line and iron and steel on the red line. As you can see, the prices of both have been rising recently – especially steel, which is now more than twice as expensive as it was four years ago. Rising costs for iron and steel will also affect fuel prices for the power industry. For example, natural gas wells and pipelines both use substantial amounts of steel, so natural gas costs will also reflect rising iron and steel prices.

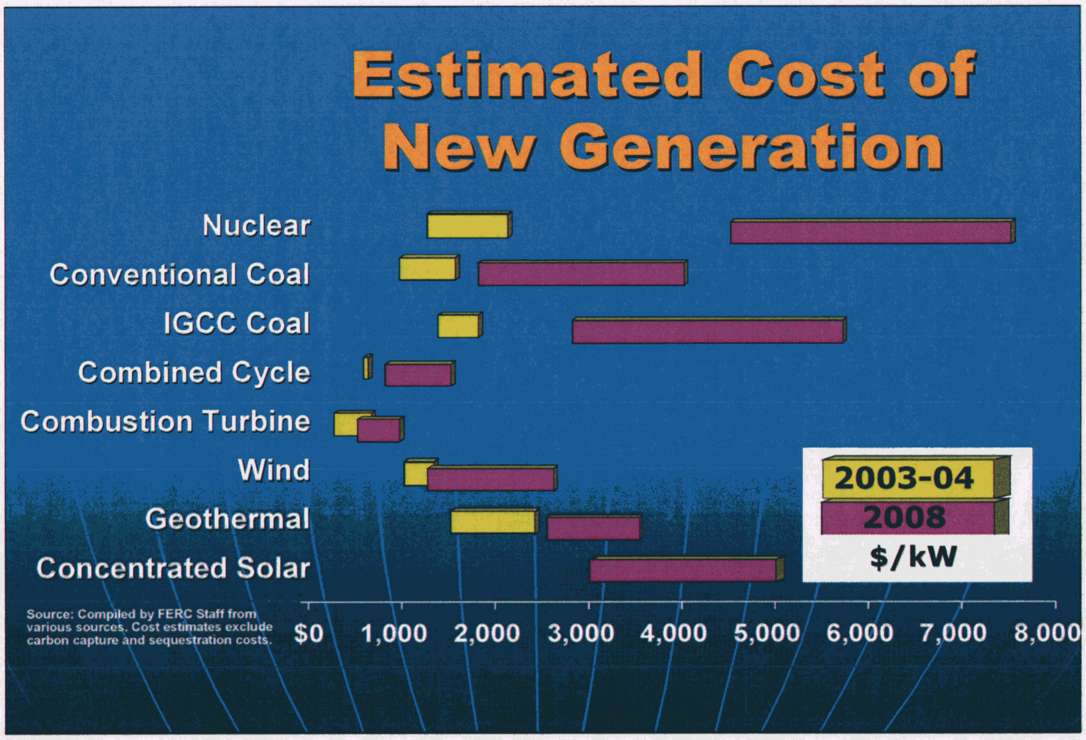


Of course, new generating plants require many other basic commodities. The slide shows the pricing for four key metals that go into generators. As you can see, all of these metals are increasing in price. The one that stands out is copper, up more than five times over the past four years. Indeed, copper is now so valuable there are reports of copper thieves cutting live cables to steal the metal.



Labor costs are also increasing. Perhaps the most frequently cited labor shortage is that for nuclear engineers. It has been a full generation since the nation built its last nuclear plant. Most of the engineers who worked on those plants are near retirement – and many have moved on to other occupations. In fact, the labor shortages are more widespread than just nuclear engineers. The slide shows that there has been about a 27% nominal change in average hourly earnings for both construction labor generally and for non-construction utility labor since 2000, outpacing inflation by over 4% for the same period.

In practice, the American labor market is quite responsive to market forces, so short-term labor shortages tend to be self-correcting over the mid-term. Still, there is no quick way to force several years of education into six months, or decades of experience into a year or two.



What do all these cost increases mean for the cost of building a new generating plant?

No one knows precisely. It's difficult to get consistent and trustworthy numbers about plant costs, both because they are commercially sensitive and because the assumptions behind them vary greatly. The numbers reflected on the slide come from a variety of sources and include different assumptions about, for example, location or exactly what facilities are included in the estimate. To take one example: Two recent nuclear procurements in South Carolina and Georgia produced cost estimates of $5,100 and $6,400 per kW, respectively, for the same technology. We have been told that most of the difference may be due to different uses of Allowances for Funds Used during Construction – AFUDC.

Despite the difficulties in being precise, the slide represents a good general indication of how capital costs have been changing. If anything, the cost estimates may be lower than the final costs of projects, if input costs continue to rise.

It's also important to remember that these cost estimates cover only capital costs. They do not include fuel costs, which as we've seen earlier will be a large factor for both natural gas and coal-fired plants. To the extent that plants do not have major fuel costs - they may be more competitive over their life cycles than would be suggested just looking at the capital costs. That would affect renewables and, to a degree, nuclear plants.

Similarly, these estimates generally do not include a full accounting of major risk factors, especially those affecting coal and nuclear plants. Both of these technologies have long lead times. That increases the chance that market conditions will change before they are complete and adds to the financial risk of building them. Nuclear plants also have risks associated with both decommissioning and waste fuel disposal. And coal plants have risks associated with the future treatment of greenhouse gases. Of course, relatively new technologies like wind and the new approaches to nuclear also have some risks, simply because they do not have the same track record of more mature technologies.

Uncertainty about future carbon regime is a key factor

Affects coal most of all

- Greater carbon emissions
- Many plant cancellations

At the least, coal builds will be delayed

Climate change has become an increasingly urgent national issue. The debate over how to address carbon dioxide emissions is lively and has already affected how companies think about investments. Until recently, rising natural gas prices made coal plants attractive. However, the national uncertainty about carbon policy has made investing in coal plants more risky. Without carbon capture or sequestration, coal unit emit about four times as much carbon as natural gas combined cycle units per MWh. Since January 2007, 50 coal plants have been canceled or postponed. Only 26 remain under construction.

Whatever the eventual result of the climate change debate, costs of producing power from both coal and natural gas are likely to increase. Moreover, as long as future climate change policy is unclear, market participants will have a considerable disincentive to invest in coal plants. Even when the issues are resolved, it remains an open question how competitive coal-fired generation will be, and it would take another four to eight years to build new coal-fired capacity.

Over the long run, the nation can meet its increasing need for generation in several ways. But for the next few years, the options are more limited, and natural gas will be crucial.

The lead times for both nuclear and coal units mean that they will not supply a significant amount of new capacity for nearly a decade.

Most people expect renewables to supply an increasing proportion of the nation's power. For the next few years, wind will almost certainly account for a large share of generation investment and will account for a growing share of overall generation. Wind power has no fuel costs, and so will generally operate when available. However, wind is a variable, weather-dependent resource. As a result, it will not make up as strong a share of the Nation's capacity needs over the next few years. Other renewables are becoming more competitive. Geothermal power is already an important resource in the west, and concentrated solar is becoming economically attractive in desert areas like the Southwest. But these sources are likely to remain relatively small in the national picture over the next few years.

Both demand response and energy efficiency will be important – I'll talk more about them on the next slide – but they are unlikely to eliminate the need for new capacity.

Overall, the most likely outcome is that natural gas will continue to be the leading fuel for new capacity over the next half decade. For example, the consulting firm, Wood Mackenzie estimates that in a carbon constrained environment, gas consumption for power will increase by 69 % by 2017. That's in addition to the 55% increase we've seen since 2000.

Over the years, we have learned repeatedly that people respond to prices. In the case of electric power, this is likely to take several forms.

First, there is likely to be more demand response. In the simplest terms, high prices at peak will lead some customers – both businesses and others – to prefer to save their money rather than use power. In fact, the first round of demand response may be both the cheapest and fastest way to improve capacity margins on many systems. The best cost estimates for the first rounds of demand response suggest that it should be available for about $165/kW, far less than any generation side options. The results of ISO-NE's first Forward Capacity Market auction last year corroborates the economic importance of demand response - 7.4 % of the accepted bids were for demand response. However, there are impediments that limit the full use of demand response. For example, most customers do not have the option to respond directly to real-time prices. As a result, they are unlikely to reduce peak consumption as much as they might prefer to if they could take advantage of the price.

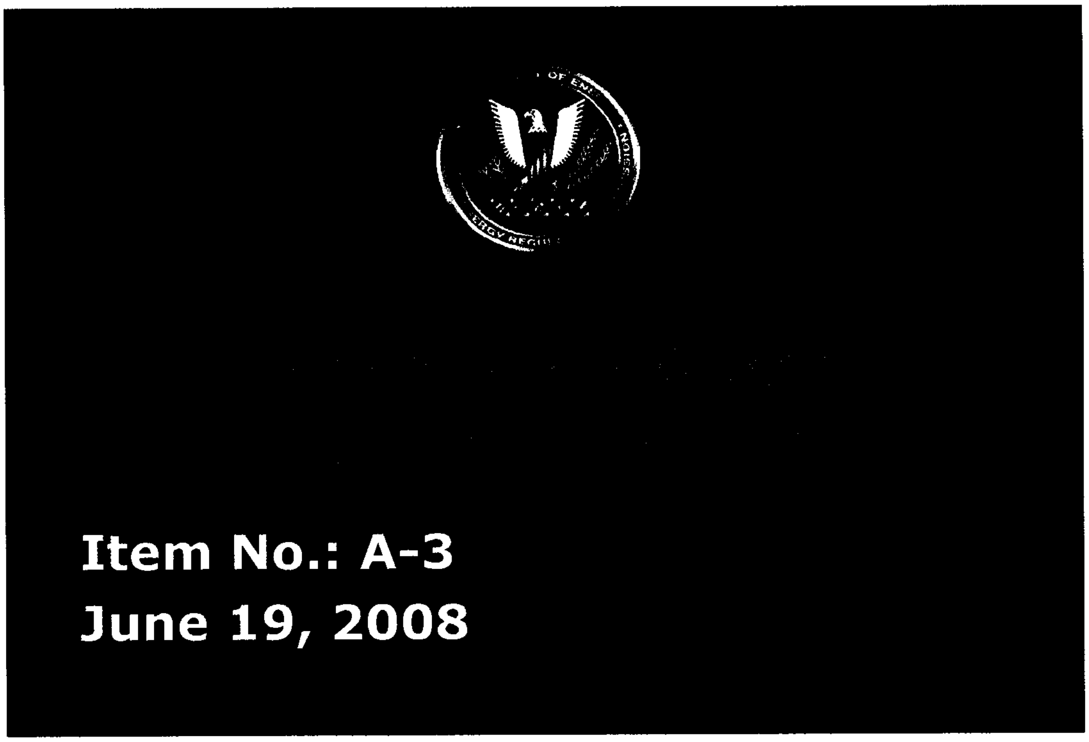
Second, customers are likely to be more energy efficient. While few customers see real-time prices, most get an average price over a month. As a result, high prices give them considerable incentive to reduce their overall consumption of power – though no more at peak than at other times. That is, energy efficiency is essentially a substitute for baseload capacity, while demand response is a substitute for peaking capacity. Energy efficiency is also likely to be economically important. Cost estimates show that the first round of energy efficiency may be available for about 3 cents/kWh. At

Continued on next page

Continued from previous page

current prices, supplying that same kWh from a combined cycle gas plant would cost 9 cents just for the fuel. Adding to the likelihood of greater energy efficiency is that many states have adopted fairly strong energy efficiency standards.

Third, innovators see higher prices as an opportunity. By the nature of things, it's hard to predict what innovations will succeed. The electric industry has a number of technologies that might take off – including concentrating solar power, hydrokinetic power, and vehicle to grid technologies. In addition, distributed generation is becoming more important, and may continue to do so for both cost and emissions reasons In other newly competitive industries, such as telecoms and natural gas, innovations have produced large changes, sometimes quickly. Given continuing high electric prices, the electric power industry may see similar results.



That concludes our presentation. We welcome comments and questions.

ARIZONA CORPORATION COMMISSION

September 5, 2008

Via E-mail Only

Thomas L. Mumaw
Meghan H. Grabel
Pinnacle West Capital Corporation Law Department
Post Office Box 53999
Phoenix, Arizona 85072-3999

William J. Maledon
Osborn Maledon PA
2929 North Central Avenue
Phoenix, Arizona 85067-6379

Robert Metli
Snell & Wilmer LLP
400 East Van Buren Street
Phoenix, Arizona 85004-2202

Re: Staff's Responses to APS' Third Set of Data Requests in Arizona Public Service Company Motion for Approval of Interim Rate and Preliminary Order and General Rate Case; Docket No. E-01345A-08-0172

Dear Messrs Mumaw, Maledon, Metli and Ms. Grabel:

Enclosed are Staff's responses to Arizona Public Service Company's Third Set of Data Requests to the Arizona Corporation Commission Staff in the above-referenced matter.

Please do not hesitate to contact me if you have any questions regarding the attached.

Sincerely,

Amanda Ho
Attorney
Legal Division
(602) 542-3402

AH:klc

Enclosure

ARIZONA PUBLIC SERVICE COMPANY'S
THIRD SET OF DATA REQUESTS TO
ARIZONA CORPORATION COMMISSION
Docket No. E-01345A-08-0172 – Interim Rate Motion
September 5, 2008

Subject: To the extent available, requested information should be provided in searchable PDF, DOC or EXCEL files via email or electronic media.

APS 3.1 The table on Page 10 of the testimony of David Parcell dated August 29, 2008, lists as its source the AUS Utility Reports of July 2007 which are Exhibit 7 to his testimony. The information contained in Exhibit 7, however, does not appear to correspond to the numbers set forth in the table on Page 10 of the Parcell testimony. Accordingly, please provide the following:

1. The name of each of the companies in each "rating" category (i.e., Aaa/AAA through Not Rated) for both rating agencies listed in the table on Page 10 of the Parcell testimony.

2. With respect to the electric-only companies listed in Exhibit 7 to the Parcell testimony, do you agree that no company has an S&P bond rating as low as or lower than PNW?

3. With respect to combination electric and gas companies listed in Exhibit 7 to the Parcell testimony, please identify those companies that have an S&P bond rating as low as or lower than PNW.

RESPONSE: **The table on page 10 of Mr. Parcell's testimony cites as its source the July 2007 AUS Utility Reports. The numbers on the table on page 10 are in fact derived from the July 2007 AUS Utility Reports, as cited. The numbers shown on the table are correct for the period stated in the source.**

Attachment 7 to Mr. Parcell's testimony (not Exhibit 7 as stated in the Data Request) shows the August 2008 AUS Utility Reports. This is not the source of the table on Page 10. The table on Page 10 should have used the August 2008 AUS Utility Reports. A revised table, similar to that on Page 10 but reflecting the August 2008 AUS Utility Reports data, is shown on the following page.

Rating	Moody's	S&P
Aaa/AAA	1	
Aa1/AA+	1	
Aa2/AA	2	1
Aa3/AA-	2	2
A1/A+	4	1
A2/A	8	8

**APS' FIRST SET OF DATA REQUESTS TO
ARIZONA CORPORATION COMMISSION
Docket No. E-01345A-08-0172
August _, 2008**

Subject: To the extent available, requested information should be provided in <u>searchable</u> PDF, DOC or EXCEL files via email or electronic media.

A3/A-	12	16
Baa1/BBB+	11	11
Baa2/BBB	**16**	13
Baa3/BBB-	3	**4**
Ba1/BB+	1	1
Not Rated	4	5

As was the case in the table on Page 10 of Mr. Parcell's testimony, the bold numbers reflect APS' current ratings. The conclusions reached by Mr. Parcell on Page 10, lines 15-16, concerning this the information contained in this table remain the same when the August 2008 AUS Utility Reports data is substituted for the July 2007 AUS Utility Reports data. Thus, the updating of the bond ratings data does not impact Mr. Parcell's testimony and conclusions.

The responses to the specific questions posed in the data request are as follows:

1. **The information requested is contained in Attachment 7 to Mr. Parcell's testimony, which is the August 2008 AUS Utilities Reports.**

2. **No, Mr. Parcell does not agree with this. PWC has a S&P bond rating of BBB- Three other companies have a BBB- rating (NiSource, TECO Energy, and Westar) and one has a lower rating (BB+ PNM Resources). One of these (Westar) is listed by AUS Utility Reports as an electric-only company. It is noteworthy that 15 of the companies have a Moody's rating of Baa2 (i.e., APS and PWC rating) and three have a lower rating. Six of these are listed by AUS Utility Reports as electric-only companies.**

3. **Of the combination electric and gas companies, two have the same S&P rating as APS and PWC and one has a lower rating. These companies are identified in the response to 2 above.**

Press Release

Tue, Sep 02, 2008

Rocky Mountain Power announces changes in its Utah business

SALT LAKE CITY, Utah, Sept. 2, 2008 — Rocky Mountain Power must change the way it serves its Utah customers due to a recent rate decision issued by the Public Service Commission of Utah. Previously, the company had sought to balance three elements of utility operations: (1) service reliability to current customers; (2) ability to serve growing loads of new and current customers; and (3) low rates. After analyzing the commission's order, the company determined the commission did not provide sufficient revenue to support the electric service levels needed to meet Utah's growing demand for electricity. The commission has signaled by its order that the primary policy of the state is to keep rates low. To achieve this state policy objective and live within the budget set by the commission, Rocky Mountain Power will be making significant changes in the way it conducts business in Utah.

In its August order the commission granted Rocky Mountain Power a 2.7 percent tariff increase against a request for a 5.6 percent increase. The company's request for additional revenue reflected the cost to serve its Utah customers during calendar year 2008. It also reflected the cost associated with supporting the state's economic development and environmental goals while satisfying its regulatory commitments. The $38 million disallowed by the commission is required to respond to growth and to operate the company in the manner that Rocky Mountain Power previously believed customers expect and deserve. Consequently, today the company will be making a legal challenge to the commission's order by filing a petition for reconsideration of the commission's order requesting formal review of its decision regarding recovery of the company's power costs, property taxes, costs associated with generation overhauls, test year and return on equity.

"For more than a decade, Utah has enjoyed one of the fastest-growing economies in the United States," said Richard Walje, president of Rocky Mountain Power. "Growth does not come without significant challenges. The company has been investing billions of dollars to ensure sufficient generation, transmission and distribution capacity is available to meet this growth. The cost of providing for increased electric consumption by existing customers and the cost of providing service to new customers has exceeded the revenue the company receives from these customers. In response, we have aggressively managed our controllable costs through business efficiencies and energy efficiency programs designed to mitigate the impacts of growth and other cost reduction measures. However, these efforts have not fully offset the increased costs of serving existing and new electrical demand in Utah."

The cost of coal, natural gas and purchased electricity is increasing rapidly. As a result, the cost of electricity Rocky Mountain Power purchases and generates to serve customers in Utah is increasing sharply – up between $16 million and $20 million every six months. The costs incurred to purchase and generate electricity to serve the company's Utah customers during the first five months of 2008 exceeded the amount of revenue provided by the commission in its August order. That order currently creates a shortfall in net power cost recovery of $16 million in Utah for the company. The order also does not take into account the higher level of fuel and purchased power costs that will be incurred by the company to serve customers over the next year. This will increase the company's shortfall by an additional $27 million. In addition to increases in net power costs, the costs for critical commodities have had double- and triple-digit increases since 2001 – steel at 350 percent, copper at 349 percent and diesel fuel at 209 percent.

Unfortunately, the amount of revenue provided the company in the commission's order does not reflect the true cost of providing electrical service, and as a result the company is unable to continue its current approach to providing service.

Therefore, effective Sept. 15, 2008, Rocky Mountain Power will implement a hiring freeze directed at positions dedicated to serving customers in Utah. In addition, the company will:

·Further curtail the use of contractors;

·Limit overtime to the restoration of power only when employee or public safety is threatened;

·Seek relief and work with appropriate parties to reduce Utah property tax payments to the level allowed by the commission, as well as explore other options;

·Eliminate discretionary maintenance, discontinue funding of research associated with renewable and clean coal technology, and discontinue support for economic development activities;

·Review the level and types of corporate philanthropy; and

·Ultimately consider curtailing electric service when the cost of purchasing electricity to serve customers in Utah is prohibitive and exceeds the funding the commission provided to purchase and generate electricity to serve customers.

The company continues to investigate additional actions that can be taken to reduce costs, including changes in the operations of the company's customer contact centers, while remaining in compliance with all local, state and federal regulations.

While these actions are necessary given the recent commission order, the primary driver of price increases – growth in the demand for electricity – must be addressed if the policy to maintain low prices inherent in the commission's order is to be achieved. Consequently, Rocky Mountain Power will aggressively work with elected officials and the commission to reduce the growth in Utah's demand for electricity.

Requests will be submitted to the Public Service Commission of Utah and, if necessary, to elected officials to mandate customer participation in electricity demand-management programs, to eliminate line extension allowances for new customers, to institute marginal pricing for large industrial customers and to send appropriate pricing signals to customers through the use of an energy cost adjustment mechanism similar to the commission-allowed adjustment Questar uses in establishing natural gas prices.

The company is evaluating the impact these changes will have on the projected growth in the demand for electricity, and will recommend other policy changes, if necessary, to ensure the delivery of safe, adequate service to customers in Utah.

Unfortunately, these actions are necessary to bring the cost of providing service in Utah in line with the revenue the company will receive based on the commission's recent decision.

"The employees and management of Rocky Mountain Power are committed to serving our Utah customers to the best of our ability and we regret the impact the recent decision of the commission will have on the level of service we are able to provide," Walje said.

Media inquiries: 800-775-7950; newsdesk@pacificorp.com

Increased Revenue Requirements on the Growth in the ACC Jurisdictional Rate Base Since APS' Last Rate Case ($m)

Line	Period	Plant Additions (1)	Less: Rate Base Deductions (2)	Net Rate Base Additions (3)	Revenue Requirement On Net Rate Base Additions (4)	Revenue Requirement On Increased Book Depreciation (5)	Total Incremental Revenue Requirement (6)	Annual Revenue Requirement Deficiency (7)
1	9/30/05 to 12/31/07	$1,114	($576)	$538	$65	$30	$95	($95)
2	2008	$838	($437)	$401	$49	$23	$72	($167) **
3	2009	$907	($444)	$463	$56	$24	$80	($247)

Notes:

** Annual revenue requirement deficiency on ACC rate base growth through June 30, 2008 equals ($139.9) million (see Mr. Rumolo's exhibit DJR_RB-1)

(1) $1,114 is the change in gross utility plant on schedule B-1 from the last ACC decision to the current case. 2008 and 2009 figures are from attachment DAK-2.

(2) Includes changes in accumulated book depreciation, deferred income taxes, and other rate base items.

(3) $538 is from attachment RCS-4. 2008 and 2009 figures are from attachment DAK-2.

(4) Equals net rate base additions x 8.32% cost of capital from the last ACC decision, adjusted for interest synchronization and the revenue conversion factor.

(5) Equals plant additions x an effective 2.7% book depreciation rate.

(6) Excludes incremental revenue requirements from additional property taxes.

(7) Equals the annual revenue requirement increase since the last test year, for rate base additions through that period.

Integrated Utility Equity Deals Since 2004

Pricing Date	Issuer	Deal Size ($mm)	Deal Size % Mkt Value	File to Offer	Offer to Current
05/29/08	Westar Energy Inc	146	6.1%	3.3%	(6.7%)
12/06/07	Empire District Electric Co	69	9.6%	(0.2%)	(8.3%)
12/05/07	Sierra Pacific Resources	204	4.9%	(4.2%)	(33.9%)
11/15/07	Westar Energy Inc	207	8.2%	(2.2%)	(10.3%)
11/08/07	Pepco Holdings Inc	176	3.5%	(3.9%)	(6.1%)
06/12/07	Portland General Electric Co	615	36.9%	(11.8%)	(1.5%)
05/11/07	Consolidated Edison Inc	559	4.1%	(0.3%)	(19.5%)
03/21/07	Energy East Corp	243	6.6%	0.4%	12.2%
12/12/06	Avista Corp	69	5.4%	(4.1%)	(11.0%)
12/06/06	PNM Resources	177	7.6%	(1.5%)	(61.7%)
09/21/06	ConEdison	447	3.8%	(0.6%)	(18.3%)
08/14/06	Cleco Corp	164	11.9%	(2.8%)	6.1%
08/10/06	Sierra Pacific Resources	282	8.8%	(2.8%)	(20.3%)
06/15/06	Empire District Electric Co	77	12.6%	(7.2%)	4.2%
05/17/06	Great Plains Energy Inc	193	8.6%	(3.0%)	82.3%
12/06/05	Northeast Utilities	439	15.3%	1.1%	40.9%
11/15/05	WPS Resources	247	12.2%	(4.7%)	(32.0%)
10/27/05	Puget Energy	312	13.0%	(2.4%)	34.1%
04/27/05	Pinnacle West Capital	256	6.3%	(1.4%)	(16.2%)
03/30/05	CMS Energy Corp	282	11.8%	(3.6%)	10.8%
03/23/05	PNM Resources	105	6.1%	(4.3%)	(55.9%)
12/09/04	Idacorp Inc	121	9.6%	(4.9%)	(0.7%)
12/07/04	Otter Tail Corp	78	10.6%	(5.3%)	56.0%
10/07/04	CMS Energy Corp	298	19.6%	(2.7%)	49.1%
09/09/04	Pepco Holdings Inc	288	7.9%	(5.4%)	31.7%
09/07/04	Dominion Resources	652	2.9%	(0.4%)	(33.2%)
08/18/04	Aquila Inc	117	19.5%	(17.2%)	NA
06/30/04	Ameren Corp	459	5.9%	(2.2%)	(0.3%)
06/28/04	Constellation Energy Group Inc	228	3.6%	(1.6%)	75.8%
06/08/04	Great Plains Energy Inc	150	6.7%	0.3%	(21.8%)
05/11/04	Consolidated Edison Inc	528	5.8%	(3.2%)	8.4%
03/25/04	Westar Energy Inc	249	14.4%	3.8%	9.7%
03/10/04	Hawaiian Electric Industries Inc	104	5.0%	(2.0%)	(49.0%)
02/03/04	Ameren Corp	875	11.3%	(3.5%)	(8.8%)
	Total/Average (34):	**9,414**	**9.6%**	**(3.0%)**	**0.2%**

Source: Dealogic as of August 29, 2008. Includes utility and power equity & equity-linked offerings greater than $50 million in proceeds.

LEHMAN BROTHERS
EQUITY RESEARCH

September 02, 2008

United States of America
Power and Utilities
Regulated Utilities

Pinnacle West Capital (PNW - US$ 35.19) 2-Equal weight

Company Update

Staff Testimony in Interim Rate Request

Daniel Ford, CFA
1.212.526.0836
daford@lehman.com
LBI, New York

Investment Conclusion

- We reiterate our 2-EW rating, our $33 price target and our earnings estimates of $2.47/$2.48E in 2008 and 2009 respectively.

Summary

- ACC Staff has filed testimony in PNW's request for interim rate relief which would put in place an interim base rate surcharge of $.003987/kWh to become effective upon the expiration of the $.003987/kWh 2007 PSA charge. This would equate to ~$115M in annual revenues and be subject to refund pending the full outcome of the current rate case filed at the ACC under docket E-01345A-08-0172.
- Staff recommended that an emergency or the conditions otherwise warranting an interim increase have not been met, however, if the ACC does grant an increase it should be ~$62M, and require the infusion of ~$400M of equity into the utility before becoming effective. The AECC, an industrial intervenor recommended an increase of ~$42M. RUCO requested an extension of testimony until today.
- We view the $400M equity infusion as difficult to meet given the current environment for equities, and specifically given that PNW's equity is currently trading below book value.

Stock Rating		Target Price	
New:	2-Equal weight	New:	US$ 33.00
Old:	2-Equal weight	Old:	US$ 33.00

Sector View: 2-Neutral

EPS (US$) (FY Dec)

	2007	2008			2009			% Change	
	Actual	Old	New	St. Est.	Old	New	St. Est.	2008	2009
1Q	0.17A	-0.04A	-0.04A	-0.04A	N/A	N/A	0.07E	-124%	N/A
2Q	0.79A	0.93A	0.93A	1.03A	N/A	N/A	0.75E	18%	N/A
3Q	1.98A	N/A	N/A	1.62E	N/A	N/A	1.66E	N/A	N/A
4Q	0.03A	N/A	N/A	-0.07E	N/A	N/A	0.00E	N/A	N/A
Year	2.96A	2.47E	2.47E	2.46E	2.48E	2.48E	2.54E	-17%	%
P/E			14.2			14.2			

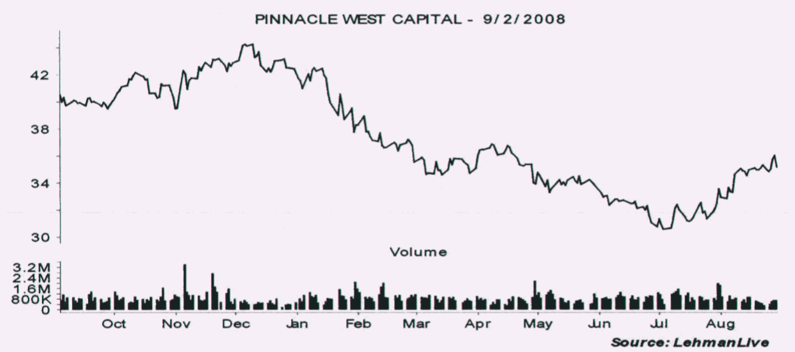
Market Data

Market Cap (Mil.)	3545
Dividend Yield	5.97
52 Week Range	44.50 - 30.26

Financial Summary

Revenue TTM (Mil.)	3628.0

Stock Overview



Analyst Certification:

I, Daniel Ford, CFA, hereby certify (1) that the views expressed in this research Company Note accurately reflect my personal views about any or all of the subject securities or issuers referred to in this Company Note and (2) no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this Company Note.

PLEASE SEE ANALYST(S) CERTIFICATION(S) ON PAGE 1 AND IMPORTANT DISCLOSURES BEGINNING ON PAGE 3

Attachment DEB_RB-7 Page 1 of 1

REBUTTAL TESTIMONY OF CHARLES J. CICCHETTI

On Behalf of Arizona Public Service Company

Docket No. E-01345A-08-0172

(Interim Rate Request)

September 8, 2008

Table of Contents

REBUTTAL TESTIMONY OF CHARLES J. CICCHETTI
ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY
(Docket No. E-01345A-08-0172)
(Interim Rate Request)

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND ADDRESS.

A. My name is Charles J. Cicchetti, and my business address is Navigant Consulting Incorporated (NCI), 300 South Grand Avenue, Los Angeles, CA 90071. I am the same Charles J. Cicchetti who previously submitted an Affidavit in Support of Arizona Public Service Company's (APS or the Company) Motion for Interim Rate. Since submitting that Affidavit, I have joined NCI as a Senior Advisor while continuing my affiliation with Pacific Economics Group (PEG) on an interim basis.

Q. HAVE YOUR CONCLUSIONS CHANGED SINCE YOU FILED YOUR AFFIDAVIT?

A. On the bigger issues, no. I have, however, learned that the interim 4 mil Power Supply Adjustor ("PSA") ended on July 31, 2008. Therefore, it will not be possible, as I urged in my Affidavit, for the Commission to simply "roll-over" the PSA into interim rate relief through a similar surcharge or amount per kWh as the PSA.

I understand further that the Company now proposes to put the interim rate relief in effect as the Company switches from the higher summer to lower winter rates. This would help consumers adjust, although I would have preferred a simple roll-over. Nevertheless, in my experience, customers would mostly agree that waiting for the lower winter rates to come into effect would also be a useful step.

Regardless, I believe the primary reason justifying an interim rate increase remains. The significant threat of a downgrade in APS's credit ratings looms unless the Company receives meaningful interim rate relief. Such relief would also partially offset the crippling impact of regulatory lag on APS.

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. I have reviewed the evidence that was submitted through Staff's consultants Mr. Ralph Smith and Mr. David Parcell, and that RUCO submitted through Mr. Stephen Ahearn. I will address in this Response why I disagree with their conclusions and continue to urge this Commission to grant APS's request for interim rate relief. By doing so, APS's declining financial condition would be addressed on an interim basis in a just and reasonable manner that would, in my opinion, advance the public interest and benefit consumers in the long run.

Q. WHAT MATTERS ARE YOU ADDRESSING?

A. The Staff's consultants and RUCO have raised two themes that I will address. These are: (1) there is no "emergency"; and (2) "regulatory lag" is ordinary and even beneficial. I will approach each issue as a former state utilities regulator and as a person with more than forty years of regulatory experience and expertise.

II. THE EMERGENCY ISSUE

Q. PLEASE EXPLAIN YOUR DISAGREEMENT WITH MR. SMITH'S VIEWS ON THE EXISTENCE OF AN "EMERGENCY."

A. I find the discussion in Mr. Smith's testimony to be a search for a single salient and dramatic event that quite literally has the financial "wolves barking at APS's door."[1] He goes on to explain that the already filed general rate case would possibly be resolved sometime in late 2009. Thus, Mr. Smith finds no emergency because APS could get away from any perceived danger in a little more than a year's time.[2]

I disagree with Mr. Smith on two levels. First, there is a ready opportunity to fix a financial problem with retail consumers paying no more than the same annual amount that they had been paying under the PSA. The current financial challenges will only get worse if not addressed before the end of 2009. The "fix" is to implement interim relief before the new rate case is decided, and this can be done without increasing rate levels beyond what they were prior to the PSA roll-off. Second, interim relief is clearly warranted from a cost-of-service standpoint and to help keep retail prices lower over time. I believe that APS should continue to invest in necessary infrastructure. Given regulatory lag, Mr. Smith suggests that APS should consider either slowing down or not completing the necessary infrastructure efforts. This would not be good for Arizona. It is also likely, with inflation of material prices, that this sort of delay would cost customers more money. Ironically, I find my conclusion to be consistent with Mr. Smith's discussion of the Net Rate Base additions and his seeming recognition that APS's rather exceptional but necessary capital expenditures would be well in excess of its cash flow from operating income (EBITDA).[3] Thus, if the "wolves" are not yet actually at the Company's door, they are certainly in the neighborhood, and they are hungry.

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[1] *See* Mr. Smith's discussion of "Alleged Emergency Circumstances" commencing on page 14 and running through page 30 of his Testimony.
[2] *See* Mr. Smith's testimony at page 30, lines 12-14.
[3] *See* Mr. Smith's Testimony at page 34, lines 4-9.

Q. HOW CAN THE COMMISSION RESOLVE THE CONFLICTING TESTIMONY AND OPINIONS EXPRESSED BY APS AND STAFF'S CONSULTANTS?

A. Obviously they need to weigh carefully the relative persuasiveness and expertise of the witnesses, but as a former regulator, I also learned the importance of thinking through matters in terms of "motive and consequences" to both consumers and the utility when competing experts or different participants in a regulatory matter took very contrary, even diametrically opposed, viewpoints. Here Staff's consultants find no immediate emergency and run off a checklist of issues that they believe proves they are correct.[4] APS and its witnesses tell a quantitative story that describes the nearly perpetual state of being "one notch away" from slipping into junk bond status according to Standard & Poors' (S&P) rating of BBB-. Staff pushes back on this observation explaining that two other rating agencies, Moody's and Fitch, give APS a bit more headroom and point to other troubled electric utilities in the nation.

Q. WHAT DO STAFF'S WITNESSES SAY ABOUT CURRENT CONDITIONS?

A. Mr. Smith and Mr. Parcell never say whether this perpetual state of financial challenge thrust upon APS is good or bad. They focus instead on whether this could be an "emergency" or not. They conclude that there is no "emergency" and, therefore, no need for interim rate relief. They fail, however, to address fully the relevant issues. APS, as Mr. Brandt explains, has significant necessary investments and faces inflated construction and material prices, which have exacerbated the negative effects of regulatory lag on APS. These combine to make it impossible to finance these capital expenditures out of operating income plus depreciation on existing infrastructure. This effort is made potentially even

[4] *See* Mr. Smith's Testimony at pages 14-30, and Mr. Parcell's Testimony at pages 9-16.

more costly and difficult because in Arizona, prudent, used and useful, necessary investments that are made before or during a general rate case begin to be depreciated before these utility investments are ever placed in Rate Base. This means that investors do not earn a portion of their return "of" these investments. In addition, there is also a zero return "on" these necessary, used and useful investments between the time they are placed into service and the future rate case when they are put into Rate Base.

Q. WHAT IS THE RELEVANCE OF THE DISTINCTION YOU DRAW BETWEEN THE RETURN "ON" AND "OF" INVESTMENTS BETWEEN RATE CASES?

A. The return "on" is the earnings on the original cost of the undepreciated investments. The return "of" original cost is synonymous with depreciation expense. This is how a regulated utility collects money to recover its principal on an investment. This depreciation or recovery "of" the original cost is the regulatory approach used to collect cash flow that can finance replacements and new investments from internal operations.

Q. ISN'T REGULATORY LAG A NORMAL PROBLEM FOR ALL UTILITIES?

A. A degree of regulatory lag is necessarily present in most jurisdictions, although usually well less than a year. The regulatory lag that has confronted APS is substantially more severe than I have seen elsewhere, does not appear to be mitigated by other ratemaking practices (e.g., attrition adjustments, interim rates, "make whole" proceedings, etc.), and is clearly detrimental to APS and its customers. These are not just normal regulatory problems for a company such as APS that needs to invest considerable amounts (in the billions of dollars) to keep up with the needs of its growing customer base. Financial analysts would and do consider these troubling signs. Financial analysts would be particularly anxious about APS if the Commission fails to grant interim rate relief given the cash-flow challenges of meeting new investments coupled with significant regulatory lag for the recovery of and return on such investments. In today's electricity industry, infrastructure delayed may also cost more to build in the future. APS is building for Arizona's future under a regulatory approach that relies on 20/20 hindsight and that often omits critical factors that increase the company's cash flow gap as it continues to build over time, and then the Company waits, with no compensation adjustment, to recover the necessary cash from customers. That is not just backward-looking, it is also decidedly not sufficient to reflect the cash flow needed and the reasonable earnings required for a utility that serves a growing service area such as the one APS serves.

Q. WOULD YOU EXPAND ON YOUR EARLIER DISCUSSION OF THE RELEVANT LESSONS YOU LEARNED AS A REGULATOR CONCERNING DISPUTES LIKE THE ONE THE COMMISSION FACES IN THIS PROCEEDING?

A. Returning to the lessons learned theme, the opposing experts and their analyses are in sharp contrast to one another. As I explained, "motives and consequences" often can help regulators cut through these technical matters when there is expert disagreement.

Although I assume both Staff's consultants and the Company witnesses have the best of motives, potential "consequences" are most important. If Staff's consultants are correct and there turns out to be no "emergency," the consequences for retail customers of granting APS's requested relief are relatively small. If APS receives interim relief, I would also expect Staff's rate case experts to urge a smaller amount of additional rate relief in late 2009 if the Commission approves the interim rate relief. Further, any interim rate relief granted would be subject to refund if found to be excessive. If the Commission determined in the (Permanent) Rate Case that the interim relief it granted was more than the rate increase it grants in the Rate Case, it could order APS to refund the amount the Commission found unwarranted, with interest. Thus, the consequences to consumers, if APS is wrong and interim rate relief was nevertheless granted, are minimal (considering that consumers are and have been receiving service below cost at current rate levels) and the Commission retains the authority to make the consumers whole if APS's interim rate relief is more than the rate relief ultimately granted in the general rate case.

Q. WHAT WOULD BE THE RESULTS IF STAFF'S CONSULTANTS' VIEWS PREVAIL, BUT THEY TURN OUT TO HAVE BEEN WRONG IN THEIR ASSESSMENT OF APS'S FINANCIAL CONDITION?

A. If the Company is correct and the Staff's consultants are wrong, there would be very different results. And none of them would be good for consumers or Arizona. Assume that the Commission does not grant interim rate relief. This would exacerbate currently soft financial conditions as APS continues to make the necessary investments without sufficient internally generated cash flow. APS would need to raise more money externally. I would expect rating agencies, including S&P, Moody's and Fitch, to either downgrade APS or at least raise enough questions to increase the cost of capital for APS and its customers. If such a downgrade occurred, retail consumers would need to pay higher prices in the future to cover the resulting higher costs of capital. APS's shareholders would not recover a reasonable return "of" the invested dollars depreciated before the next base rate case and, in my opinion, APS would fail to earn its just and reasonable authorized return "on" its investments. Worse, this vicious cycle could be viewed as a permanent condition that would mean APS customers would face the prospects of higher prices to pay for more expensive investment in the future. This means that consumers would likely be paying much more for the same services than they would otherwise have been paying had the Commission granted the interim rate relief. Worse, these needlessly higher prices will continue for many years to come.

As a former regulator, I would urge you to give considerable additional weight to my observation that the adverse consequences to APS customers of failing to act to avoid an emergency greatly exceed the consequences to those same customers of granting APS the interim rate relief requested.

III. REGULATORY LAG: THE GOOD, THE BAD, AND THE UGLY

Q. WHY DO YOU DISAGREE WITH MR. SMITH'S VIEWS CONCERNING THE BENEFITS OF REGULATORY LAG?

A. Mr. Smith states that "Ordinary regulatory lag does not justify APS's Requested Interim Rate Relief."[5] In this regard, Mr. Smith makes two arguments. First, he seems to conclude that the amount of money that APS is losing is just too small for there to be an emergency and, therefore, APS can postpone relief to the general rate case.[6] Second, Regulatory Lag is, in his mind and at least theoretically, a benefit that improves utility performance.[7]

I disagree with Mr. Smith on both points. I will not dwell on the numbers he discusses except to say these do not seem to be quite so trivial and to observe that he ignores the fact that without emergency rate relief: (1) new money not fully covered by operating cash flow will be invested; (2) cash flow will decline; and (3) the negative effect on APS will increase until at least the end of 2009. These are the very matters that analysts, who determine APS's ratings and thus

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[5] *See* Mr. Smith's Testimony at pages 11-14.
[6] *See* Mr. Smith's Testimony at page 14, lines 15-19.
[7] *See* Mr. Smith's Testimony at page 12, line 23 through page 13 line 17.

the cost of capital consumers will pay in the years ahead, have already told us are the very things that they will be following carefully.

Q. WHAT ARE SOME OF THE RELEVANT PARTICULARS AT THIS TIME CONFRONTING APS?

A. Some of the salient particulars are that Mr. Smith thinks APS overstates its arguments because about $297 million of capital expenditures occur after December 31, 2007 and would not be in the historic test year filed in 2008.[8] He also thinks that APS would recover cash from depreciation expenses, and he argues that the amount of new Rate Base would "only" increase about $538 million at the end of the December 31, 2007 test year for the "New" general rate case.[9]

As I count these two effects, Mr. Smith is saying that sometime in 2008, APS has about $835 million in likely-to-be-prudent utility investments that it would not receive a return "on" or "of" until the end of 2009, at the earliest. At that time, as I understand Mr. Smith's approach to regulation, which is predicated in part on the efficacy of his "good" regulatory lag, $297 million (plus the additional amounts invested later in 2008 and 2009) would still not be included in Rate Base until yet another subsequent rate case.

Taking a very conservative fraction of the conservative $835 million in new investments not included in Rate Base to recover depreciation, property taxes, and a return would, in my experience, result in increased annual revenue requirements of about $170 million, give or take $10 million. Mr. Smith seems to think that regulatory lag will result in a temporary delay in APS recovering

[8] *See* Mr. Smith's Testimony at page 12, lines 5-6.
[9] *See* Mr. Smith's Testimony at page 12, lines 16-20.

this revenue. He is mistaken. This loss in revenue is permanent. APS will never be able to recover the full original cost of its capital expenditures. Further, some of the future authorized return "on" that now depreciated investment would, in effect, be needed to repay the portion of the investment "of" that would be lost to such depreciation during the period of regulatory lag. There are no regulatory provisions in Arizona, as far as I understand things, to recover lost depreciation or even the higher property taxes paid in the period between rate cases. Again, and contrary to Mr. Smith's implication, these losses are permanent to APS. Further, these lost recovery opportunities are nearly fifty percent more than the $115 million in interim rate relief APS seeks. These foregone cost recoveries are neither "too small" to matter, in my opinion, nor do they represent mere "timing" differences.

Q. DOES REGULATORY LAG PRODUCE "GOOD" EFFECTS FOR ARIZONA?

A. No. Mr. Smith seems to believe these massive losses will do some "good" in the form of encouraging more management emphasis on "cost control" than would be the case if consumers paid for "plant additions during the periods between rate cases."[10] He also opines that regulatory lag could cause a utility to question whether it might "be prudent to delay or avoid the related capital expenditures."[11]

APS is a rather uniquely high growth utility that struggles perpetually to stretch thin cash flow against the stark reality of high capital expenditure requirements. Mr. Smith's notion that APS consider cutting back on capital expenditures to serve customers would negatively affect service, could well lead to higher costs

[10] *See* Mr. Smith's Testimony at page 13, lines 5-8.
[11] *See* Mr. Smith's Testimony at page 13, line 13.

in the future, and would likely have a negative effect on Arizona's economy, especially in light of the recent mortgage, housing, and construction slowdown.

Q. ARE THERE ANY "BAD" EFFECTS?

A. This severe gap is bad for shareholders, and it also means higher cost of capital for retail consumers in Arizona. There is nothing "good" about this severe gap. Indeed, these bad things are exacerbated further because Arizona uses an historic test year in an environment of high growth and high capital outlay requirements. As I understand rate cases in Arizona, the Commission can adjust for "known" changes between test years, but that such adjustments are discretionary and are often highly contested. Accordingly, there is a strong element of risk involved and typically no use of prospective attrition adjustments or after-the-fact "make-whole" relief in recent years. Thus, APS forfeits the recovery "of" depreciation and return "on" plant placed in service and used to serve customers between rate cases.

APS is constantly challenged to stay ahead of the curve because of regulatory lag in Arizona. Regulatory lag is especially bad for a utility, like APS, that is forced to spend substantial amounts to accommodate the growth on its system. Regulatory lag is "bad" when it forces a utility constantly to seek relief from its Commission. It is bad for consumers to receive delayed and watered down price signals because this can influence consumption decisions. It is also bad for consumers if the result is a weakened utility. In my opinion, the Commission should balance the interests of both shareholders and consumers by providing APS with a greater cushion against the possibility of a "junk" debt rating, rather than providing APS with the bare minimum it needs to maintain its current minimum investment grade rating. This should prove to be a "win-win" for both

APS and its customers in the long term because it would lower the cost of capital and benefit consumers for decades to come.

Q. DO YOU AGREE WITH RUCO WITNESS MR. AHEARN'S CONCLUSION THAT REGULATION IN ARIZONA "HAS WORKED FAIRLY AND RATIONALLY FOR DECADES"[12] AND THAT APS IS ATTEMPTING TO REDEFINE THE "REGULATORY PARADIGM IN ARIZONA."[13]

A. No. I do not agree that the examples he cites of state regulations or policies that other states have used are in any respect unfair, unjust, or irrational. Indeed, I have been involved in regulation for more than four decades, and I am very familiar with regulatory practices that include: automatic adjustors, interim/emergency rates; single issue ratemaking; decoupling mechanisms, and "ACRM-like mechanisms." Mr. Ahearn condemns each of these as creating a "new regulatory system" that would shift risk to ratepayers.[14]

I strongly disagree that this is what other state Commissions have done when they sometimes approve or adopt such mechanisms. More important, I believe that when state regulators have ordered utilities to use such regulatory mechanisms, they do so to reduce future regulated utility prices and/or to promote the public interest.

Q. WHAT WOULD IT TAKE FOR THESE EFFECTS OF REGULATORY LAG TO TURN "UGLY"?

A. The "ugly" face of regulatory lag has not occurred in Arizona. And by "ugly," I mean a downgrade of APS to "junk" and a resulting inability to finance needed infrastructure at a reasonable cost. This would result from a losing struggle between necessary APS construction confronting insufficient cash flow and no

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[12] *See* Mr. Ahearn's Testimony at page 7 line 1.
[13] *See* Mr. Ahearn's Testimony at page line 23.
[14] *See* Mr. Ahearn's Testimony at page 7, lines 1-5.

or unduly delayed rate relief. Again, the likely outcome would be the lowering of bond ratings to junk status and higher future costs of capital resulting in higher retail prices in Arizona. Quite simply, there is no "good" regulatory lag when the Company has to recover large capital expenses to meet its customers growing needs and to ensure system reliability.

IV. CONCLUSION

Q. WHAT SHOULD THIS COMMISSION TAKE AWAY FROM YOUR TESTIMONY?

A. Mr. Ahern concludes these are not extraordinary times; therefore, do not grant "extraordinary relief" or allow "non-traditional ratemaking."[15] I think that APS's growth and infrastructure investment requirements in today's global environment are extraordinary. The financial analysts and rating agencies have granted APS a bit of a reprieve, but they are poised to act to downgrade APS's bonds if they see signs that the Commission does not appreciate APS's financial problems due to inadequate cash flow, significant new investments, and a regulatory lag that does not and cannot make APS whole.

I urge the Commission to fix this immediate problem with interim rate relief before it becomes a crisis. In effect, it is better to evacuate when there are storm warnings than to try and ride out the impending storm, let alone clean up after. Staff's consultants and RUCO either ignore the warnings or believe the Commission should wait for the storm to hit. This would not be prudent, and it is not good for consumers. The Commission can act before the next rate case is decided without raising prices above the level they were this past July. I urge it to do so.

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[15] *See* Mr. Ahearn's Testimony at page 7, lines 13-15.

Q. DOES THAT CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.

REBUTTAL TESTIMONY OF DAVID J. RUMOLO

On Behalf of Arizona Public Service Company

Docket No. E-01345A-08-0172

(Interim Rate Request)

September 8, 2008

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REBUTTAL TESTIMONY OF DAVID J. RUMOLO
ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY
(Docket No. E-01345A-08-0172)
(Interim Rate Request)

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is David Rumolo. My business address is 400 North Fifth Street, Phoenix, Arizona 85004.

Q. BY WHOM ARE YOU EMPLOYED AND WHAT IS YOUR POSITION?

A. I am employed by Arizona Public Service Company ("APS" or "Company") as Manager of Regulation and Pricing. I am responsible for the establishment and administration of APS tariffs and contract provisions that are under the jurisdiction of the Arizona Corporation Commission ("Commission"). I am also responsible for certain aspects of APS tariffs that fall within the jurisdiction of the Federal Energy Regulatory Commission ("FERC").

Q. WOULD YOU DISCUSS YOUR EDUCATIONAL BACKGROUND AND BUSINESS EXPERIENCE?

A. My background and experience are set forth in Appendix A to this testimony.

Q. HAVE YOU FILED ANY PREVIOUS TESTIMONY REGARDING THE PROPOSED INTERIM RATE INCREASE?

A. Yes, on July 11, 2008, I filed an affidavit that addressed alternative rate designs for the interim rate increase. That affidavit described three alternatives; a kilowatthour charge that would be applicable to all affected customers, a percentage method that would apply the same percentage to all affected customers, and a hybrid in which the revenue responsibility is assigned to customer classes on a per kWh charge but is collected from commercial and industrial customers on the basis of demand. In each case, customers who are eligible to receive low-income discounts under the provisions of Rate Schedules E-3 and E-4 would be exempt from the interim increase. As described in my affidavit, APS has no preference regarding the three options.

II. SUMMARY

Q. WOULD YOU SUMMARIZE YOUR REBUTTAL TESTIMONY?

A. My rebuttal testimony focuses on two areas. First, I provide a discussion on the interim revenue requirement that was computed by Staff Consultant Ralph Smith. Mr. Smith provided his revenue requirements computation as an alternative should the Commission determine that APS should be allowed an interim increase. Mr. Smith's calculations are based on the plant additions made by APS between the test year rate base in APS's last rate case (TYE 9/30/2005) to the unadjusted test year rate base found in the current rate case filing (TYE 12/31/2007). He computed the increased revenue requirements of approximately $65 million associated with the return on investment for the increased plant investment. In my rebuttal testimony, I note that Mr. Smith failed to include other fixed costs associated with plant investment, most notably depreciation and property taxes.

My testimony provides analyses of several additional alternatives that build on the concept developed by Staff Consultant Smith. The alternatives include developing the revenue requirements for plant additions that are in service and serving customers today but are not included in current rates. For example, utilizing data found in the direct testimony of APS Witness Daniel Kearns in the APS permanent rate case, I added the revenue requirements associated with known and measurable generation plant additions as of June 30, 2008. The addition of the generation plant alone increases the interim rate increase revenue requirements to $118 million which exceeds the interim increase requested by the Company.

Second, my rebuttal testimony addresses the rate design testimony submitted by Mr. Smith and by Arizonans for Electric Choice and Competition ("AECC") Witness Kevin Higgins. In his testimony, Mr. Smith suggests that should the Commission authorize interim rate relief, the per kilowatthour rate design is the preferred approach. Mr. Higgins testimony indicates that the percentage approach is more appropriate. My testimony comments on the testimony of Mr. Smith and Mr. Higgins.

III. REVENUE REQUIREMENTS ANALYSES

Q. HAVE YOU REVIEWED THE REVENUE REQUIREMENTS ANALYSIS PREPARED BY STAFF WITNESS RALPH SMITH?

A. Yes, I have. Mr. Smith's testimony states that if the Commission desired to provide some level of interim rate relief, the appropriate level of the relief would be approximately $65 million. His testimony notes that this level was developed by comparing the rate base level authorized by the Commission in APS's last rate case in Decision No. 69663 and the unadjusted rate base for the test year ending December 31, 2007. Mr. Smith then applies the rate of return authorized in Decision No. 69663 to the change in rate base to develop the revenue requirement with the appropriate change in interest synchronization.

Q. DO YOU AGREE WITH THE APPROACH UTILIZED BY MR. SMITH?

A. The steps undertaken by Mr. Smith are mathematically correct, but I do not believe that he has fully applied his methodology.

Q. PLEASE ELABORATE ON YOUR LAST COMMENT.

A. Mr. Smith calculates the return on some but not all of the increased capital investment since the last rate case test year. However, he does not include the other fixed costs of that capital investment, the largest of which are return of capital through depreciation expense and property taxes.

Q. ARE THERE OTHER COSTS THAT HAVE NOT BEEN INCLUDED IN MR. SMITH'S CALCULATIONS?

A. Yes, plant-related fixed operations and maintenance expenses associated with the new facilities have not been included. As APS installs more equipment, fixed operations and maintenance expenses related to that equipment also increase. However, these costs are relatively small compared to those I have already identified, namely return, depreciation, and property taxes.

Q. HAVE YOU ADJUSTED MR. SMITH'S CALCULATIONS FOR THE ADDITIONAL REVENUE REQUIREMENTS DUE TO DEPRECIATION EXPENSE AND PROPERTY TAXES?

A. Yes, I did. Attachment DJR_RB-1 demonstrates the calculations. I began with Mr. Smith's calculations, added depreciation expense and property tax expense for the increased plant in service as of December 31, 2007. These two cost factors increased the interim revenue requirements to approximately $107.7 million. I also have not included the increased revenue requirements that result from operations and maintenance expenses for the reasons discussed above.

Q. HAVE YOU COMPUTED THE RATE IMPACTS OF MR. SMITH'S ALTERNATIVE AND YOUR MODIFICATION TO THAT ALTERNATIVE?

A. Yes. Adjusted 2007 test year billing determinants, excluding the energy associated with customers receiving low-income discounts, amount to 28,405,086 MWh. Mr. Smith's alternative would yield a rate of $0.0023 per kWh. With APS's modifications to Mr. Smith's alternative, a rate of $0.0038 per kWh would yield the revenue requirements of approximately $107.7 million.

Q. HAVE YOU EXAMINED OTHER MODIFICATIONS TO MR. SMITH'S REVENUE REQUIREMENTS COMPUTATIONS?

A. Yes. Since the end of the 2007 test year, APS has completed construction of several significant additions to our generation investment that have been placed in service. We have added the steam generator upgrades for Palo Verde Unit #3, the Yucca combustion generator units in Yuma and APS's share of the environmental construction upgrades at the Cholla Plant. These projects have added approximately $184 million to jurisdictional rate base since the close of the 2007 books. The revenue requirement increase resulting from these generation additions is approximately $10.6 million using the rate of return authorized in Decision No 69663. When added to the $107.7 million computed previously, the interim revenue requirement (again excluding increased operations and maintenance expenses) is approximately $118.4 million or $0.0042 per kWh.

Q. DID YOU EXAMINE ANY OTHER ALTERNATIVES?

A. Yes. We examined all the jurisdictional plant balances closed to utility plant as of 6/30/2008 net of accumulated depreciation, deferred taxes and retirements. As of that date, APS had added over $350 million in utility plant, including the generation additions described in my previous answer, and distribution plant compared to the 12/31/2007 test year rate base. Using Mr. Smith's same calculation method (including the plant additions from the end of the last rate case test year thru 12/31/2007), plus the addition of depreciation expense and property taxes, an interim rate increase of $137.9 million could be supported. This amount recognizes the fixed costs of the net rate base invested by APS since the end of the last rate case test year. Again, I have not included any expense adjustments to reflect increased operations and maintenance expenses.

Q. DO YOU BELIEVE THAT THE CALCULATIONS YOU HAVE DESCRIBED ARE CONSERVATIVE?

A. Yes, I do. The generation plant additions that I described are based on the rate base value of the plant as of October 2009 per the pro forma calculations found in the rate case testimony of APS Witness Daniel Kearns. Today's rate base value would be slightly higher due to lower accumulated depreciation, i.e. partial year depreciation compared to full year. Also, we have used the rate of return authorized in Decision No. 69663, not the rate of return requested in our current rate case. Finally, as I noted in the previous question, we have not attempted to adjust any operations and maintenance expenses for the increased plant investment.

Q. DOES ATTACHMENT DJR_RB-1 PROVIDE THE CALCULATIONS FOR EACH OF THE ALTERNATIVES THAT YOU HAVE DESCRIBED?

A. Yes it does. The attachment replicates the calculations of Mr. Smith (Scenario 1), then adds depreciation and property tax expense (Scenario 2). Scenario 3 adds the impact of the generation plant investment additions to Scenario 2. Scenario 4 demonstrates the calculations incorporating the changes between

12/31/2007 and 6/30/2008 in non-transmission plant additions (including generation additions), increased accumulated depreciation and deferred taxes.

IV. RATE DESIGN

Q. HAVE YOU REVIEWED THE TESTIMONY OF STAFF AND AECC REGARDING RATE DESIGNS FOR IMPLEMENTING THE INTERIM REQUEST?

A. Yes, I have. Staff Consultant Ralph Smith proposes that should the Commission approve an interim rate change, it should be applied to customer bills on the basis of a per kilowatthour charge. AECC Witness Kevin Higgins proposes that the interim increase be assessed on a percentage basis, with the same percentage applied to all customer classes. Although neither Mr. Smith nor Mr. Higgins specifically address the APS suggested exemption for customers who receive low income discounts under Rate Schedules E-3 and E-4, I have assumed that Staff and AECC are supportive of that exemption.

Q. IN YOUR AFFIDAVIT, YOU INDICATED THAT APS IS WILLING TO UTILIZE ANY OF THE THREE METHODS THAT YOU DESCRIBE. IS THAT STILL THE COMPANY'S POSITION?

A. Yes it is. As noted in my affidavit, the per kWh approach tends to benefit small energy users such as residential customers but is a disadvantage for large consumers of energy. The percentage method tends to favor large users. For small users, the per kWh method is beneficial since the basic service charge fixed fee is a larger percentage of the total bill than for large users. A percentage would be applied to the total base bill, including the basic service charge. Other adjusters, taxes, etc. would be excluded from the percentage adder. The opposite is true for large users. The energy component of the customer's bill is a significant portion of the total bill, therefore, a percentage method would yield a smaller increase than a per kWh charge.

The third method as described in my affidavit allocates the revenue responsibility on a per kWh basis but collects on a capacity basis from general service customers who are billed with a rate demand component. The effect of that method is to re-allocate the revenue responsibility within the general service customer class. AECC is correct in noting that this is a hybrid approach, but it is the hybrid approach that has been used by the Commission with regard to other costs such as recovery of demand side management program costs.

APS believes that each of the approaches are equally simple to implement, administer and track should there be a need to make refunds in the future.

V. CONCLUSION

Q. WOULD YOU PLEASE SUMMARIZE CONCLUSIONS REACHED IN YOUR REBUTTAL TESTIMONY?

A. My rebuttal testimony addresses the following key issues: 1) Staff Consultant Ralph Smith provides a reasonable approach to computing the revenue requirements that could be used to compute interim rate relief if done properly. 2) The Staff method omits two plant investment expenses, depreciation and property taxes. These are fixed investment carrying costs that the company bears when plant is placed in service. Adding these cost elements to Mr. Smith's approach increases the interim relief from approximately $65.2 million to $107.7 million. 3) The Staff approach should be further expanded to recognize, at a minimum, the additional generation plant investments that have been completed in 2008. The interim rate relief with that addition would be approximately $118.4 million. If the interim relief was based on all non-transmission plant added through 6/30/2008, the interim revenue requirements would be approximately $137.9 million. 4) APS expresses no preference regarding the rate design that will be applied to customer bills should the commission grant interim relief.

Q. DOES THAT CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes.

Appendix A
Statement of Qualifications
David J. Rumolo

David J. Rumolo is Arizona Public Service Company's Manager of State Pricing. He has over 32 years experience in the electric utility business as a consultant and utility professional. Mr. Rumolo holds Bachelor of Science Degrees in Electrical Engineering and Business (Finance as an area of emphasis) from the University of Colorado. He is a registered professional engineer in the states of Arizona, California, and New Mexico.

Mr. Rumolo's areas of expertise include utility Rate Schedule design; embedded and marginal cost analysis; formulation of utility service policies; contract development and negotiation; utility valuation analyses; and evaluation of utility revenue requirements. Mr. Rumolo has testified on utility matters before state regulatory bodies in the states of Arizona, Colorado, Florida, and Wyoming and before judicial bodies in the states of Arizona and California. Mr. Rumolo is also experienced in the many aspects of electric utility planning and design including preparation of long-range resource plans; transmission and distribution system long range planning; system protection analyses; and reliability assessments.

Mr. Rumolo has held his current position at Arizona Public Service Company for approximately seven years. Prior to assuming that position, he served as the Manager of Transmission and Market Structure Assessment for Pinnacle West Energy Corporation ("PWEC"). Before joining PWEC, Mr. Rumolo had a 15-year career as a consultant with Resource Management International, Inc., where he provided utility Rate Schedule and engineering consulting services to utility clients across the United States and overseas. He began his career providing consulting services to utility clients when he joined the firm of Miner and Miner Consulting Engineers in Greeley, Colorado where he became the Manager of Planning and Rate Schedules. He later became a partner in Electrical Systems Consultants where he focused on cost of service and Rate Schedule analyses, as well as transmission and distribution planning.

Arizona Public Service Company
Computation of Increase in Gross Revenue Requirement
On Change in Rate Base Since Decision No. 69663
ACC Jurisdictional

Test Year Ended December 31, 2007
(Thousands of Dollars)

Line No.	Description	Scenario 1 Staff Direct Testimony	Scenario 2 Staff Direct Testimony With Increased Depreciation & Property Tax Expense	Scenario 3 Staff Direct Testimony With Proformas - PV Unit 3 SG, Cholla, & Yucca Units 5&6	Scenario 4 6/30/2008 (g) Plant Additions
1	Adjusted Rate Base Additions	$ 537,987	$ 537,987	$ 585,653	$ 696,424
2	Rate of Return	8.32%	8.32%	8.32%	8.32%
3	Operating Income Required	$ 44,761	$ 44,761	$ 48,726	$ 57,942
4	Net Operating Income Available	$ 5,209	$ 5,209	$ 5,671	$ 6,743
5	Operating Income Excess/Deficiency	$ 39,552	$ 39,552	$ 43,055	$ 51,199
6	Gross Revenue Conversion Factor	1.6491	1.6491	1.6491	1.6491
7	Base Rate Revenue Increase for Interim Rates Due To Change in Rate Base	$ 65,225	$ 65,225	$ 71,002	$ 84,432
8	Depreciation Expense Adjustment	$ -	$ 30,588 (a)	$ 34,464 (b)	$ 38,848 (c)
9	Total Revenue Requirement Increase with Deprec. Expense	$ 65,225	$ 95,813	$ 105,466	$ 123,280
10	Property Tax Adjustment	$ -	$ 11,919 (d)	$ 12,907 (e)	$ 14,615 (f)
11	Total Revenue Requirement Increase	$ 65,225	$ 107,732	$ 118,373	$ 137,895
12	Retail Revenue Requirement Increase per $/kWh	$ 0.0023	$ 0.0038	$ 0.0042	$ 0.0049

(a) Depreciation Expense Adjustment factor of 2.746% based on 2007 Depreciation Expense (FERC Form 1, Page 219, Line 10) divided by 2007 Total Electric Plant In Service (FERC Form 1, Page 207, Line 104) applied to change in Gross Utility Plant in Service from Schedule B-1 (ACC - Column (D), Line 1) for TYE 9/30/2005 and TYE 12/31/2007.

(b) Proforma Depreciation Expense from Schedule C-2 (ACC - Column B, D & F - Line 10) added to Depreciation Expense in Scenario 2.

(c) Depreciation Expense Adjustment factor of 2.746% based on 2007 Depreciation Expense (FERC Form 1, Page 219, Line 10) divided by 2007 Total Electric Plant In Service (FERC Form 1, Page 207, Line 104) applied to change in Gross Utility Plant in Service from Schedule B-1 (ACC - Column (D), Line 1) for TYE 9/30/2005 and TYE 12/31/2007 and 6/30/2008 plant additions.

(d) Property Tax Expense Adjustment factor of 1.07% based on 2007 Real & Personal Property Charged Taxes (FERC Form 1, Page 263, Line 9, 17, 26 & 31) divided by 2007 Total Electric Plant In Service (FERC Form 1, Page 207, Line 104) applied to change in Gross Utility Plant in Service from Schedule B-1 (ACC - Column (D), Line 1) for TYE 9/30/2005 and TYE 12/31/2007.

(e) Proforma Property Tax Expense from Schedule C-2 (ACC - Column B, D & F - Line 13) added to Property Tax Expense in Scenario 2.

(f) Property Tax Expense Adjustment factor of 1.07% based on 2007 Real & Personal Property Charged Taxes (FERC Form 1, Page 263, Line 9, 17, 26 & 31) divided by 2007 Total Electric Plant In Service (FERC Form 1, Page 207, Line 104) applied to change in Gross Utility Plant in Service from Schedule B-1 (ACC - Column (D), Line 1) for TYE 9/30/2005 and TYE 12/31/2007 and 6/30/2008 plant additions.

(g) Includes generation plant shown in Scenario 3.

Arizona Public Service Company
Interest Synchronization

Test Year Ended December 31, 2007
(Thousands of Dollars)

Line No.	Description	Scenario 1 Staff Direct Testimony	Scenario 2 Staff Direct Testimony With Increased Depreciation & Property Tax Expense	Scenario 3 Staff Direct Testimony With Proformas - PV Unit 3 SG, Cholla, & Yucca Units 5&6	Scenario 4 6/30/2008 Plant Additions
1	Change in Jurisdictional Rate Base	$ 537,987	$ 537,987	$ 585,653	$ 696,424
2	Weighted Cost of Debt	2.46%	2.46%	2.46%	2.46%
3	Synchronized Interest Deduction	$ 13,234	$ 13,234	$ 14,407	$ 17,132
4	Difference (decreased) increased interest deduction	$ 13,234	$ 13,234	$ 14,407	$ 17,132
5	Combined Federal and State Income Tax Rates	39.360%	39.360%	39.360%	39.360%
6	Increase (decrease) to Income Tax Expense	$ (5,209)	$ (5,209)	$ (5,671)	$ (6,743)
7	Increase (decrease) to Net Operating Income	$ 5,209	$ 5,209	$ 5,671	$ 6,743

Arizona Public Service Company
Summary of Rate Base Change
From Decision No. 69663
ACC Jurisdictional

Test Year Ended December 31, 2007
(Thousands of Dollars)

Line No.	Description	Scenario 1 Staff Direct Testimony	Scenario 2 Staff Direct Testimony With Increased Depreciation & Property Tax Expense	Scenario 3 Staff Direct Testimony With Proformas - PV Unit 3 SG, Cholla, & Yucca Units 5&6	Scenario 4 6/30/2008 Plant Additions
1	Decision No. 69663	$ 4,403,496	$ 4,403,496	$ 4,403,496	$ 4,403,496
2	Current Case - Unadjusted (12/31/2007)	$ 4,941,483	$ 4,941,483	$ 4,941,483	$ 4,941,483
3	Adjusted Rate Base	$537,987	$537,987	$537,987	$537,987
4	Palo Verde Unit 3 Steam Generator (a)			$ 92,199	
5	Cholla Generating Station Env. Projects (b)			$ 15,608	
6	Yucca Units 5 & 6 (c)			$ 75,758	
7	Increase in ACC Accumulated Deferred Income Taxes			$ (135,899)	
8	Revised Adjusted Rate Base			$585,653	
9	6/30/2008 ACC Post Test Year Plant Additions (d)				$ 343,220
10	Increase in ACC Accumulated Depreciation Reserve (e)				$ (48,884)
11	Increase in ACC Accumulated Deferred Income Taxes				$ (135,899)
12	Revised Adjusted Rate Base				$696,424

(a) Filed Schedule B-2 (Column D)

(b) Filed Schedule B-2 (Column F)

(c) Filed Schedule B-2 (Column H)

(d) Increase calculated by subtracting FERC Form 1 Functional Plant In Service numbers (Pages 204-207, Column (g)) from Form 3-Q: Quarterly Financial Report for 2008/Q2 (Page 208, Column (b)) exclusive of transmission plant. This number includes production proformas from Scenario 3 and is net of retirements.

(e) Increase calculated by subtracting 12/31/2007 Year End Balance from Current End of Quarter Balance [Form 3-Q: Quarterly Financial Report for 2008/Q2 (Page 110, Column (d-c))] exclusive of transmission.