APS ORIGINAL

0000093901

Leland R. Snook
Director
State Regulation & Pricing

Tel. 602-250-3730
Fax 602-250-3003
e-mail Leland.Snook@aps.com

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

February 20, 2009

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

RE: Arizona Public Service Company's Comments on Investigation of Regulatory and Rate Incetives for Gas and Electric Utilities
Docket Nos. E-00000J-08-0314 & G-00000C-08-0314

Arizona Corporation Commission Staff has scheduled a workshop pertaining to energy efficiency on March 6, 2009. To facilitate discussions at the workshop the Commission Staff requested responses from interested parties to various questions to be filed in Docket Control by February 20, 2009. Attached are Arizona Public Service Company's comments.

If you have any questions please call Jeff Johnson at 602-250-2661.

Leland R. Snook

Attachments

LS/dt

CC: Lyn Farmer
Janice Alward
Ernest Johnson
Parties of Record

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COPY of the foregoing was mailed or emailed this 20th day of February, 2009, to:

Lawrence V. Robertson, Jr.
P.O. Box 1488
Tubac, AZ 85646

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

C. Webb Crockett
Patrick J. Black
Fennemore Craig
3003 North Central, Suite 2600
Phoenix, AZ 85012-2913

Jodi Jerich
Daniel Pozefsky
RUCO
1110 West Washington, Suite 220
Phoenix, AZ 85007

Michael A. Curtis
William P. Sullivan
Larry K. Udall
Curtis, Goodwin, Sullivan, Udall & Schwab, P.L.C.
501 E. Thomas Road
Phoenix, AZ 85012-3205

Jay I Moyes
Karen Nally
Moyes Storey LTD
1850 N. Central Ave, Suite 1100
Phoenix, AZ 85004

Gary Yaquinto
President & CEO
Arizona Utility Investors Association
2100 N. Central Avenue, Suite 210
Phoenix, AZ 85004

Michael M. Grant
Gallagher & Kennedy, P.A.
2575 East Camelback Road
Phoenix, AZ 85016
Attorneys for AIC

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

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

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

Michael Kurtz
Kurt J. Boehm
BOEHM, KURTZ & LOWRY
36 E. Seventh Street, Suite 2110
Cincinnati, OH 45202

Creden Huber
Sulphur Springs Valley Electric Cooperative, Inc
P.O. Box 820
Wilcox, AZ 82311

Ladel Laub
Dixie-Escalante Rural Electric Association, Inc
71 East Highway 56
Beryl, UT 84714-5197

Carl Albrecht
Garkane Energy Cooperative, Inc
P.O. Box 465
Loa, UT 84747

Jeffrey Woner
K.R. Saline & Associates, PLC
160 N. Pasadena, Suite 101
Mesa, AZ 85201

Richard Adkerson
Ajo Improvement Company
P.O. Drawer 9
Ajo, AZ 85321

Jack Shilling
Duncan Valley Electric Cooperative's Gas Division
P.O. Box 440
Duncan, AZ 85534-0440

Dennis True
Morenci Water and Electric Company
P.O. Box 68
Morenci, AZ 85540

Douglas Mann
Semstream Arizona Propane, LLC
200 W. Longhorn
Payson, AZ 85541

Russ Barney
Graham County Utilities, Inc
P.O. Drawer B
Pima, AZ 85543

Gray Grim
Arizona Electric Power Cooperative, Inc
P.O. Box 670
Benson, AZ 85602

David Western
Trico Electric Cooperative, Inc
P.O. Box 930
Tucson, AZ 85702-0711

Paul O'Dair
Navopache Electric Cooperative Inc
1878 W. White Mtn Blvd
Lakeside, AZ 85929

Scott Canty
The Hopi Tribe
P.O. Box 123
Kykotsmovi, AZ 86039

Marcus Middleton
Copper Market, Inc.
P.O. Box 245
Bagdad, AZ 86321

Paul Griffes
Mohave Electric Cooperative, Inc
P.O. Box 1045
Bullhead City, AZ 86430

Michael Fletcher
Columbus Electric Cooperative, Inc
P.O. Box 631
Deming, New Mexico 88031

David Couture
UNS Electric, Inc
P.O. Box 711
MS UE201
Tucson, AZ 85702

Randy Sable
Southwest Gas Corporation
MS LVB-105
5241 Spring Mountain Road
Las Vegas, NV 89150

Meridith Strand
Southwest Gas Corporation
MS LVA-120
5241 Spring Mountain Road
Las Vegas, NV 89150

Brooks Congdon
Southwest Gas Corporation
MS LVB-100
5241 Spring Mountain Road
Las Vegas, NV 89150

Laura Sanchez
NRDC
1500 Lomas Blvd. NW, Suite B
Albuquerque, NM 87104

John Wallace
GCSECA
120 North 44th Street, Suite 100
Phoenix, AZ 85034

Jeff Schlegel
SWEEP
1167 W. Samalayuca Drive
Tucson, AZ 85704

Comments of Arizona Public Service Company
On Energy Efficiency
February 20, 2009

On January 30, 2009, the Arizona Corporation Commission ("Commission") Utilities Division requested that interested parties respond to questions relating to energy efficiency. The parties' responses would help facilitate discussions at the Commission's Energy Efficiency Workshop, which is scheduled for March 6, 2009. Arizona Public Service Company's ("APS" or "Company") comments are provided below. APS looks forward to participating in the Energy Efficiency Workshop.

Energy Efficiency in Arizona: Existing Programs and Measures

1. **Which energy efficiency programs and program strategies are most effective in assisting particular customer segments such as low and moderate income residential customers, households on fixed incomes, customers in existing homes (owner occupied and rental), schools, local governments, small businesses, and large businesses?**

   The current APS Portfolio of demand side management ("DSM")[1] programs has proven to be effective to reach almost all customer segments. The Energy Wise Low Income Weatherization program provides free home weatherization and bill assistance to qualified low income customers. For moderate income customers and households on fixed incomes, APS offers discounts on energy efficient compact fluorescent light bulbs ("CFLs"), which can save more than $40 in energy costs over the lifetime of the bulb for a purchase price of approximately one dollar. For customers in existing homes, APS offers rebates to customers who replace their air conditioning units with high efficiency equipment and repair and seal leaks in air conditioning ductwork—measures that can save hundreds of dollars a year in energy costs.

   For business customers (including commercial, industrial and institutional and government customers), the Large Existing Facilities Program provides prescriptive incentives for high efficiency motor, lighting, cooling, and refrigeration replacements in existing large facilities, as well as a custom incentive for other projects. The New Construction Program provides incentives for upgrading the energy efficiency of newly constructed commercial and industrial buildings. The Small Business Program offers incentives that are specifically targeted to improve the efficiency of small business customers. The Schools Program specifically targets program incentives for all school facilities, including public and private primary and secondary schools. The Energy Information Service Program provides incentives to encourage customers to install special interval load data meters and to subscribe to a software service that provides

[1] In these comments, APS uses the terms "demand side management" or "DSM," and "energy efficiency" interchangeably.

information on the business' energy use, as a means for customers to identify energy efficiency actions that will reduce their energy use. All five of these non-residential DSM programs are marketed to customers under the umbrella program of "APS Solutions for Business."

The current portfolio of programs has proven to be both successful and cost effective. Since 2005, when the APS DSM Portfolio was developed, through June of 2008, APS has spent a total of $44.8 million on DSM programs and achieved cumulative annual savings of 531,889 megawatt hours ("MWh") at a cost of approximately one cent per lifetime kilowatt hour ("kWh"), making it one of the lowest cost resources available. As a result of the Commission-approved DSM programs, APS has been awarded the Environmental Protection Agency ("EPA")/ Department of Energy ("DOE") Star Partner of the Year award for Excellence in Energy Efficiency Program Delivery for the past three years.

2. What studies have the Arizona utility companies or other parties conducted over the past decade regarding the various energy efficiency options available in Arizona?

APS has completed a high-level assessment of the potential for DSM programs in the Company's service territory. This DSM Market Potential Study was filed with the Commission on September 12, 2007 in Docket No. E-01345A-05-0182. The Market Potential Study concluded that the realistic cost-effective potential for DSM programs in the APS service territory was in the range of 2,600 to 3,900 gigawatt hours ("GWh) by 2020, given a reasonable set of assumptions regarding incentive levels and customer acceptance. This range of savings represents approximately 7% to 10% of expected GWh sales in 2020. The study also identified potential energy efficiency technologies and the estimated technical, economic, and market potential for energy efficiency within the APS territory for each major customer segment.

(a) Which options produced the best in energy savings/costs?

Overall, APS believes that the Company's current portfolio of DSM programs offers the best in energy savings/costs, evidenced to date by the current cost of approximately one cent per kWh over the expected lifetime of all program measures that have been installed.

(b) Which produced the most energy efficient jobs?

Neither APS nor the DSM Market Potential Study has analyzed the impact of programs as related to the production of jobs in the energy efficiency industry.

(c) Please provide data for, but not limited to, the following options:

(i) Home Energy Audits

- **Online audits**:

  An on-line energy self-audit delivered through the Internet is a cost-effective option for delivering audit recommendations to a broad range of customers. A key benefit of an online audit is that interaction with the audit tool teaches customers about effective home energy improvements, as well as ways to improve energy usage behavior. In 2008, APS customers completed more than 20,000 online audits through the Company's website, aps.com. We believe that customers who complete the APS on-line audit may subsequently save energy; however, the actual savings have not been quantified.

- **Onsite audits:**

  On-site energy audits provide a valuable tool to identify energy efficiency savings opportunities. APS currently offers a program called "Home Performance with Energy Star" that delivers a detailed and comprehensive on-site energy audit, complete with advanced diagnostic tools such as infrared cameras, duct blasters, and blow doors that provide detailed information on where homes are leaking energy. However, the costs of delivering these on-site energy audits and the difficulty of converting potential opportunities into actions that save energy can make on-site audits cost prohibitive. The typical cost for the diagnostic testing is $300-$500 per home.

  To address this concern, APS and other Arizona utilities are currently participating in a statewide applied research project ("Arizona Home Performance") that is funded by DOE and managed by the Arizona Energy Office. The project will conduct home energy retrofits on a number of different housing types throughout the different climates of Arizona to develop a process to streamline delivery of home performance energy efficiency retrofits. APS believes that this valuable project can be a catalyst for greater opportunities with energy efficiency audits and home retrofits in the state.

(ii) Solar water heater systems

Ten Arizona utilities, including APS, engaged the Shelton Group to conduct survey research in the fall of 2006 to better understand Arizona homeowners' perceptions and awareness of renewable energy—particularly solar energy. The research also explored homeowners' likelihood to purchase and install solar water heaters and solar energy systems in order to estimate potential participation in utilities' renewable energy incentive programs.

(iii) Insulation/weatherization of residential properties and commercial properties

For low income residential properties, the APS Energy Wise Low Income Weatherization program offers field data based on the actual energy efficiency savings and costs as a result of weatherization. For other existing housing stock, the "Arizona Home Performance" applied research project described above should offer relevant data on the cost and savings from a coordinated energy audit and retrofit effort. The Arizona Home Performance project began in late 2008; preliminary results are expected in late 2009, and the final project reports are anticipated in 2010.

As far as commercial buildings are concerned, the 2007 APS Energy Efficiency Market Potential Study analyzed weatherization measures such as insulation, cool roofs, infiltration reduction, and high performance windows/glazing. In addition, APS submitted a cool roof measure evaluation study to Commission Staff in 2008 as part of the 13 Month Filing evaluation. Measure analysis spreadsheets were developed for both cool roofs and high performance window glazing, and were supplied to Commission Staff as part of APS's 13 Month Filing Report in 2007.

(iv) Incentives and rebates for ENERGY STAR appliances

APS has been studying the potential for incentives and rebates for energy efficient appliances since 2005. The Commission found that the Company's initial proposal in 2005 to offer education and potential rebates for ENERGY STAR appliances was not cost effective. APS has since screened these measures several times with updated inputs. Most appliances are still not cost effective; however, recent changes in the ENERGY STAR clothes washer standards and newer incremental costs indicate that they are now marginally cost effective.

Issues with ENERGY STAR appliance cost effectiveness are due to a combination of factors including: 1) some ENERGY STAR appliances, such as refrigerators, do not provide enough incremental savings relative to standard appliances; 2) some ENERGY STAR appliances, such as dishwashers, already have a high market penetration (currently more than 90% of all dishwashers sold in Arizona are energy efficient); and 3) some ENERGY STAR appliances, such as clothes washers, provide good savings but have a significantly higher cost than standard models.

(v) Landscaping to provide shading and passive solar

APS recognizes that landscaping can have a role in energy efficiency; however, we also understand the tenuous nature of its cost effectiveness. The Company conducted an initial cost effectiveness screening of a residential shade tree program in 2007. This initial screening indicated that a landscaping measure could be cost effective; however there are many variables involved that could affect the actual effectiveness of the measure in the field, including specific tree placements, species shade coverage, mortality rates, and cost of obtaining and planting the trees, among other factors.

Energy Efficiency in Arizona: New Programs and Measures

3. How can the energy efficiency efforts and programs be increased to provide even more benefits to customers? Specifically, how can the energy efficiency programs reach more customers and provide greater energy savings for each customer?

There are many tools and opportunities available to expand the reach and impact of energy efficiency programs. These include, but are not limited to, expanding funding for the current programs, increasing program advertising/marketing activities to reach more customers, adding new program measures (to provide greater opportunities for savings for each customer), increasing the commercial customer annual rebate caps (greater savings per customer), increasing rebates to cover a higher percentage of a customer's incremental costs (to reach more customers), adding a second higher tier efficiency level to existing programs to provide higher incentives for greater levels of energy efficiency (greater savings for each customer), and bundling the marketing of different measures to achieve greater savings.

4. **Are there additional cost effective energy efficiency programs or enhancements of programs that should be implemented? What new energy efficiency programs or measures, such as direct install, could be implemented to enhance energy efficiency for utility customers?**

APS has presented a number of potential new energy efficiency program ideas to the APS DSM Collaborative for consideration and feedback. These include:

RESIDENTIAL NEW CONSTRUCTION:

A current APS program is the ENERGY STAR home program, where developers receive incentives to construct new homes that incorporate energy savings features and building techniques that result in homes that are at least 15% more energy efficient than standard homes. The APS ENERGY STAR Homes meet or exceed strict EPA ENERGY STAR high efficiency standards. An ENERGY STAR home includes tight construction, properly installed insulation, right-sized heating and cooling systems, fresh air ventilation and energy-efficient windows. A certified independent contractor tests the homes to ensure they perform efficiently. There are potential new ENERGY STAR programs that are currently being discussed, including:

- Higher tier "ENERGY STAR Plus" program, with higher incentives for meeting higher energy savings standards.
- ENERGY STAR for manufactured homes, which would address a common type of housing stock for moderate income and rural Arizona households.

RESIDENTIAL EXISTING HOMES:

- Incentives/rebates could be made available for new high efficiency pool pumps and smart pool timers that automatically adjust filter run times on a seasonal basis.
- Incentives for shade screen retrofits provide high value and relatively low cost for older existing homes.
- A refrigerator recycling program could offer a rebate to encourage customers to dispose of older, less-efficient "second" refrigerators.
- Insulation and window upgrades provide additional energy efficiency; however, APS has screened these measures and found them to be marginally cost effective. Insulation cost effectiveness depends on the current level of attic insulation; wall insulation retrofits are not cost effective. Window rebates may be cost effective, but only in situations where customers are already

replacing windows and the rebate is used to encourage them to upgrade to higher efficiency replacements.

- Programmable thermostats that have pre-programmed settings to regulate a home's temperature may provide energy savings. However, it is unclear how much energy these thermostats may save, because it is dependent on the individual customer's energy use habits.

- Incentives/rebates for upgrading clothes washers to ENERGY STAR appliances has some potential, although these have been screened and found to be not cost effective in the past. However, changes in ENERGY STAR standards, incremental costs, and other factors in the analysis have changed and recent screening indicates that these appliances may be marginally cost effective.

NEW AND EXISTING BUSINESSES:

For commercial customers, APS believes that the current Custom Incentive measure provides a broad opportunity to incent a wide range of commercial customer efforts that lead to energy savings. In addition, APS recently received Commission approval for a direct install program for schools and small businesses, which will assist them in evaluating and implementing energy efficiency projects. In this program, APS provides trade allies a direct incentive of up to 90% of customer incremental costs to implement lighting and refrigeration measures at the customer's facilities. Based on results in other states, APS is optimistic that the direct install program will increase participation in the hard-to-reach small business segment, and help schools (who have been one of the most active participants in APS's programs to date) to continue to implement DSM measures to a greater degree.

Regulatory Elements

5. Are there specific actions the Commission should take to support energy efficiency programs?

Yes. Currently utilities have no incentive to reduce sales (which is the ultimate result of energy efficiency programs), since lower sales result in lower earnings. Commission action that addresses and minimizes the financial disincentives would motivate utilities to increase their investments in energy efficiency programs. The Commission could also adopt policies that would further encourage greater customer participation in DSM programs, such as raising the current commercial customer annual incentive limitations, allowing programs to cover a higher percentage of customer incremental cost, and revisiting the current approach regarding the impact of tax credits on customer rebate levels.

6. **Are there procedural options available to the Commission to accelerate progress toward increased energy efficiency?**

Yes. The Commission could adopt policies to accelerate the implementation of energy efficiency programs by streamlining the regulatory approval and oversight process. This would allow programs to be available to customers more quickly and allow the programs to be more easily adjusted to respond to changing market conditions. For instance, historically it has taken approximately a year between program filing and approval. We believe that this extended time period for analysis and review could be reduced if the utilities and Commission Staff utilized the same benefit/cost test models to prove the cost effectiveness of programs. In addition, allowing the utilities broader flexibility to adjust individual program budgets and shift funds between program budgets would result in further optimization of the savings achieved for the dollars spent, and allow the utilities to better respond to economic cycles in the marketplace.

Societal Goals

7. **Would an annual energy efficiency standard or goal heighten the utilities' incentive to manage energy efficiency programs to maximize results?**

No. APS manages approved energy efficiency programs to maximize results with the resources available, and that would not likely differ if the programs are standard driven as compared to being established using predetermined spending levels. However, addressing the inherent disincentive that results from reduced sales from energy efficiency would be more likely to incent utilities to propose additional energy efficiency programs.

8. **What energy savings goals or standards should be set to increase energy efficiency in Arizona? How should an energy efficiency standard or goal be based (for example on load or total resources), and at what level?**

APS supports the development of a state-wide standard as long as it is carefully developed with provisions to account for a number of factors outside of the utilities' control that can affect the ability to achieve an energy efficiency goal through utility programs. A key example of these "outside factors" is the need for customer participation. A utility has little control of certain circumstances, such as the current economic downturn, which may hinder customers from investing in energy-saving measures.

It is important to understand that an energy efficiency savings standard represents a substantial paradigm shift from current DSM program policy. Currently, programs are established based on targeted annual levels for DSM spending. APS works with the DSM Collaborative Group, which includes Staff, RUCO, the Southwest Energy Efficiency Project, Western Resource Advocates, the Arizona Energy Office, Arizonans for Electric Choice and Competition and other interested

parties, to develop our DSM programs. The Commission Staff then reviews the program plans to ensure that all programs are cost effective. So although the program plan is based on a targeted spending level, cost effective DSM spending does result in commensurate DSM energy savings. The advantage of a spending target is the cost certainty it provides for our customers.

An energy efficiency standard could be based on load or total resources, but it must be properly aligned with the objectives of the programs (*i.e.*, energy efficiency versus peak demand reduction as the primary focus). Development of a savings goal should be done within the proper context and treatment of such a goal—meaning that both the savings goal and associated DSM program budgets would have to be viewed with flexibility. If a savings goal is adopted, it would need to supplant the current spending targets; however, the savings goal must be realistically benchmarked against the authorized DSM spending level. DSM spending levels must take into account the impact on customer bills that might be necessary to achieve the energy savings target, with a contingency plan to address funding flexibility and adapt to business cycles. In fact, it is expected that as the "low hanging fruit" becomes harvested in the early years of a DSM program, it will become increasingly expensive to achieve DSM savings. Setting a savings goal without proper funding would be counterproductive.

Another issue is the establishment of the proper baseline upon which to compare savings. APS recommends that a baseline year be established for measuring energy efficiency savings, and that any changes to building codes and appliance standards subsequent to that baseline year should either be counted toward the goal, or the goal should be modified to remove the impact of those building codes and standards changes. This would ensure that unforeseen future changes to building codes and standards do not compromise the ability to achieve energy efficiency goals from DSM programs.

Additionally, given the difficulties in predicting future technologies and with the current uncertainties in the market, it would be wise to consider a process where savings targets would be re-visited periodically (perhaps every 2-3 years) to incorporate information about emerging technologies and their potential energy savings, any changes in the costs of implementing DSM programs, any changing needs for energy efficiency in the state, and changes in consumer behavior.

Finally, establishing an energy savings target should be done in conjunction with a plan to remove the disincentive for utilities to increase their investment in DSM and hence to decrease the amount of their sales.

9. How should the results of energy efficiency programs be publicly reported so that Arizona consumers can easily assess the effectiveness of those programs?

Public reports should be easy to access and understand, and should be based on existing reporting requirements to limit redundancies and administrative overhead.

One possible approach would be a simple "scorecard" format that could be accessed on a consumer-friendly website. Energy savings goals and achievements could be reported on the website, with the savings translated into meaningful equivalents that average consumers could understand, such as equivalent number of homes that could be powered with the energy saved, equivalent gallons of gasoline saved, or the number of cars removed from roads.

Impacts on Utilities

10. What are the likely impacts on utility companies of increasing energy efficiency?

Some positive impacts of energy efficiency programs for a utility include a reduction in fuel costs and carbon emissions, and the potential to defer certain investments in generation and transmission infrastructure over the long term. However, the full value of these benefits will be diminished or unrealized if these results also include significant erosion of revenue that utilities face as a result of successful DSM efforts.

Incentives/Funding

11. What role can or should decoupling play in efforts aimed at energy efficiency?

The term "decoupling" is used to describe a variety of ratemaking methods that separate the connection between utility sales volumes and margins. Decoupling can address multiple factors for variations in per-customer margins (such as weather or economic cycles) or can be targeted to specific factors, such as energy efficiency. APS believes targeted decoupling is more appropriate in the context of energy efficiency. Targeted decoupling focuses only on the sales lost from energy efficiency programs and allows the utility to receive the same total revenue that it would have received had its sales not been reduced by those programs. This targeted energy efficiency decoupling approach is preferred over the total revenue decoupling because it isolates the impact of the DSM programs.

Targeted decoupling is one of a number of tools that can be used to address the utility financial disincentive to adopting greater energy efficiency. It can play a role in encouraging greater energy efficiency, but the relative merits of targeted decoupling as compared to other approaches will depend on the particular situation.

12. In addition to decoupling, what other incentives, such as performance incentives, could be used to counter the disincentive of reduced sales that arise from energy efficiency programs?

There are a number of approaches in addition to targeted decoupling that can be used to counter the disincentive of reduced sales, including lost revenue adjustments and establishing forward looking test years that take anticipated DSM savings into account. These approaches are distinct from, and in addition to, the various types of performance incentives for maximizing savings.

13. How should a performance incentive be structured?

Effective performance incentives are those that are most successful at encouraging greater energy savings. A number of techniques are currently being used in other states including: shared savings (similar to the current APS Performance Incentive that is based on a share of program net benefits), performance targets (where utility incentives increase as annual savings reach certain set savings target thresholds), and capitalization of energy efficiency costs, which allows the utility to earn a return on investments in energy efficiency.

14. How can funding mechanisms be modified to increase utilitiies' incentive to more fully engage in energy efficiency programs?

Funding mechanisms should be designed to address three distinct issues including:

- Timely recovery of all prudent DSM program costs;
- A mechanism (such as an adjustment or targeted decoupling) to address uncovered fixed costs resulting from DSM; and
- A performance incentive to encourage maximum benefits.

15. Is additional funding needed for energy efficiency programs and, if so, what level of funding would produce the most benefits in relation to the cost?

To provide substantially more DSM programs would require additional funding. APS's views DSM as a valuable resource that the Company will implement so long as it is: a) cost effective; b) there are sufficient numbers of APS customers willing and able to participate in the programs to achieve the desired energy savings; and c) APS's financial condition is not weakened by the erosion of revenues that result from the implementation of the DSM programs. Further analysis of APS future plans for energy efficiency is included in the Company's Resource Plan Report, which was filed in Docket No. E-01345A-09-0037.

16. If the Federal Economic Recovery package is adopted and includes significant funding for energy efficiency programs, how best should these monies be spent to enhance energy efficiency in Arizona?

The federal economic recovery legislation, the American Recovery and Reinvestment Act of 2009, was signed into law on February 17, 2009. The Company is evaluating the specific impacts of this comprehensive legislation, but it appears clear that there is a strong preference for "quick-start" activities – those activities that can be started and completed expeditiously. For that reason, APS believes if federal funding is available to the Company for energy efficiency programs, the most expeditious approach would be to integrate additional funding into our established DSM programs. (APS is assuming that stimulus funding from Congress would be additional funding and would not replace the DSM program funding currently authorized by the Commission.) The existing DSM programs have already been determined to be cost-effective programs, have proven track records, and have accountability measures in place.

It is important to note, however, that there are a number of questions regarding future federal funding of these programs that remain unanswered. For example, it is still unclear to whom or how energy efficiency funding would be made available, how funds would be accounted for, and what the specific implementation requirements would be. What role will state agencies, such as the Commission, play in implementation and will federal funds still be subject to existing state limitations on program structure? For example, will additional federal funds be allowed to be used to pay a higher percentage of a customer's incremental cost of installing energy efficient equipment or will the funds be restricted to only finding more customers willing to install energy efficiency measures at the same share of incremental cost? APS hopes these questions can be quickly resolved and looks forward to working with the Commission to expeditiously and effectively use any federal funding that may become available to expand and enhance the Company's energy efficiency efforts.

17. What specific energy efficiency programs, measures or delivery mechanisms would produce the most results from additional funding?

If federal funding becomes available, APS believes that the expansion of its low income programs should be a priority. For example, in addition to providing more funding for the Energy Wise Low Income Assistance Program, federal funding could be used to expand the Public Service Assistance Program, a program that was approved in Decision No. 70654 (December 18, 2008) as part of APS's 2009 Renewable Energy Standard ("RES") Implementation Plan, which packages the installation of solar hot water heaters with home weatherization.

Additionally, APS is currently working with the Arizona Energy Office and other Arizona energy providers, through a grant from the Department of Energy, to survey certain neighborhoods to determine whether cost-effective energy

efficiency measures could be implemented on a development-wide basis. Additional federal funding could be used to expand this pilot program. Further, if the federal legislation allows for new programs, APS is planning to propose new programs that promote energy efficiency. New programs should be added based on their cost effectiveness, savings potential, and ability to address customers across various market segments.