**BEFORE THE ARIZONA CORPORATION COMMISSION**

COMMISSIONERS

KRISTIN K. MAYES, Chairman
GARY PIERCE
PAUL NEWMAN
SANDRA D. KENNEDY
BOB STUMP

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|---|---|
| IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF THE UTILITY PROPERTY OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN THEREON, TO APPROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN | DOCKET NO. E-01345A-08-0172<br><br>**NOTICE OF FILING TESTIMONY IN SUPPORT OF PROPOSED SETTLEMENT AGREEMENT** |

Pursuant to the Procedural Order issued by the Arizona Corporation Commission on May 11, 2009, Arizona Public Service Company files the Direct Settlement Testimony of the following witnesses in support of the Proposed Settlement Agreement dated June 12, 2009:

1. Jeffrey B. Guldner
2. James R. Hatfield
3. David J. Rumolo
4. James M. Wontor
5. Barbara D. Lockwood

RESPECTFULLY SUBMITTED this 1st day of July 2009.

PINNACLE WEST CAPITAL CORP.
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Attorneys for Arizona Public Service Company

ORIGINAL AND 13 COPIES OF THE FOREGOING filed this 1st day of July 2009 with:

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AND copies of the foregoing emailed or mailed this 1st day of July, 2009 to Parties of Record

Donna Turner

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# DIRECT SETTLEMENT TESTIMONY OF JEFFREY B. GULDNER

## On Behalf of Arizona Public Service Company

## Docket No. E-01345A-08-0172

July 1, 2009

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**DIRECT SETTLEMENT TESTIMONY OF JEFFREY B. GULDNER ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY (Docket No. E-01345A-08-0172)**

I. INTRODUCTION

**Q. PLEASE STATE YOUR NAME AND ADDRESS.**

A. My name is Jeffrey B. Guldner. 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 Vice President of Rates and Regulation for APS. In that role, I am responsible for rate, regulatory and regulatory compliance matters before the Arizona Corporation Commission ("Commission") and the Federal Energy Regulatory Commission ("FERC") that affect the Company.

**Q. WHAT IS YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND?**

A. I joined APS in 2004 as Director of Regulatory Compliance, and then assumed responsibility for federal regulation and policy at the Company. Prior to joining APS, I was a partner in the Phoenix, Arizona office of Snell & Wilmer LLP, where I practiced energy and public utilities law. My practice focused primarily on electric utility rate and regulatory matters, including rate cases, power plant and transmission line siting, energy project finance, and utility mergers. Before practicing law, I was a Surface Warfare Officer in the United States Navy. I received a J.D., *magna cum laude*, from Arizona State University and a B.A. in political science from the University of Iowa.

## II. SUMMARY

**Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

A. My testimony supports the Settlement Agreement ("Agreement") that was filed with the Commission on June 12, 2009 and recommends that the Commission approve the Agreement. I discuss the settlement process, give an overview of the Agreement's key provisions, and explain why APS believes the Agreement achieves a reasonable balance of the interests of all stakeholders in APS's rate case, results in just and reasonable rates, and is in the public interest. APS's Chief Financial Officer, Jim Hatfield, will address other policy matters and the financial impact of the Agreement on APS. Additionally, details about some of the specific terms of the Agreement are presented in the Direct Testimony of James Wontor (energy efficiency provisions), Barbara Lockwood (renewable energy provisions), and David Rumolo (rate and rate schedule related matters).

**Q. PLEASE SUMMARIZE YOUR TESTIMONY**

A. The Agreement being presented to the Commission is supported by advocates of all of the customer classes served by APS—residential, commercial, industrial, and low income—as well as by representatives of virtually every interest in the case, including renewable resource proponents, energy efficiency and demand response supporters, merchant generators and competitive suppliers, schools, individual large customers, military bases, investors and unions. That such a broad spectrum of diverse interests supports the Agreement is remarkable. The Agreement is a constructive resolution that, quite simply, could not be achieved in litigation both because of the adversarial nature of that process and because many of the provisions of the Agreement are either unlikely to have been adopted or could not be mandated outside of a settlement.

The Agreement proposes an incremental rate increase of 5.4% above the interim rate increase authorized by the Commission in 2008. Together, the total amount of the base rate increase resulting from this rate case, net of fuel, is 7.9%. This level of rate increase was less than sought by APS in its Direct Testimony, but more than that recommended by Staff and RUCO in their Direct Testimonies. It reflects a compromise that, when balanced with all other provisions of the Agreement, was minimally adequate for APS to both improve its financial strength and undertake the commitments it has made in the Agreement, including the infusion of significant amounts of new equity required for the Company to make and support investments in Arizona's energy future.

In addition to proposing rate levels, the Agreement creates a framework for future rate cases. The framework is intended to avoid the situation where APS immediately files another rate case after the conclusion of this one. Instead, it proposes a schedule for rate cases to 2015, providing more structure and predictability to the Commission, the parties and our customers. The Agreement also institutes performance measures, reporting requirements and a benchmarking process that reflects the alignment of APS's management objectives with Commission policies and attempts to ensure that the Commission has information on which to judge APS's operational and cost management performance during this timeframe.

Finally, the Agreement contains detailed and far-reaching provisions necessary to promote a sustainable energy future for Arizona. These include provisions for new and expanded commitments for renewable resources, the first energy efficiency goal for any electric utility in Arizona, demand response programs, and new rate options for customers. But it is not just the commitment to pursue these resources and programs that is reflected in the Agreement—it is the financial support to achieve that vision that is equally critical. Having a desire or even a proposal to advance a sustainable energy future is not enough without the stable financial base from which such a future can be built.

Like all good settlements, no party left the process with everything that they sought or would have sought in litigation. And, certain provisions of the Agreement include commitments by APS that could not be imposed on the Company in a normal litigated rate case. But the Signatories, including APS, ultimately concluded that the Agreement reached after four months of negotiation, discussion, and compromise was appropriately balanced and in the public interest. APS believes that this Agreement is in the public interest, and I urge the Commission to approve the Agreement.

## III. SETTLEMENT PROCESS

**Q. PLEASE PROVIDE A BRIEF OVERVIEW OF THE SETTLEMENT PROCESS.**

A. This Agreement resulted from over four months of formal and informal negotiations among the majority of the parties to APS's rate case. Settlement discussions began after the resolution of the Company's interim rate request and after the submission of Direct Testimony by Staff and other intervening parties on December 19, 2008 and January 9, 2009, but before the submission of APS's rebuttal case. From APS's perspective, a collaborative settlement process provided an opportunity to develop more creative solutions and options to some of the important policy issues in the rate case than would be possible through litigation.

Formal settlement discussions between all participants occurred regularly throughout the process, from the end of January until the Agreement was ultimately filed on June 12, 2009. In addition, a group of parties not including APS that represented a wide spectrum of interests (the "Joint Parties") met separately from the Company and parties such as the Arizona Investor's Council and IBEW. The Term Sheet was filed on May 4, 2009, after the parties believed a settlement in principle had been reached. From then until June 12, 2009, the parties reduced the settlement in principle to writing and resolved the remaining outstanding issues. I would note that in addition to the signatories to the Agreement, SCA Tissue North America and Catalyst Paper Corporation, both industrial customers of APS, have subsequently filed letters indicating their support for the Agreement.

**Q. HOW WAS THE SETTLEMENT PROCESS CONDUCTED?**

A. The settlement process consisted of several months of arm's-length negotiations between 20 parties representing diverse interests. All parties to the Docket—not just those that actively participated in the settlement—were notified of settlement meetings, were invited to attend those meetings either in person or telephonically through a dial-in number, and were given the opportunity to fully participate in discussions regarding every issue on the table. Adjustments were made to meeting agendas and schedules to the extent possible to accommodate the scheduling needs of parties who expressed meeting conflicts and indicated a desire for such accommodation.

Meeting participants were provided with copies of all documents presented during the discussions. Hard copies of such documents were given to the parties in attendance and electronic copies of documents were distributed to all participating parties using a pre-established e-mail distribution. To permit and encourage openness and transparency, the parties agreed that the content of settlement discussions would be confidential, as they are generally in civil litigation under Arizona's Rules of Civil Procedure.

Although parties had a wide array of separate interests that were strongly advocated throughout the settlement process—from the promotion of renewable energy and energy efficiency, to consideration of rate impacts on residential and commercial customers, to the protection of low income customers—the settlement process resulted in an Agreement that APS believes provides benefits to <u>all</u> parties and stakeholders collectively, in addition to being in the public interest. The professionalism and commitment that ran throughout the settlement process was impressive, as evidenced by the large number of signatories to the final Agreement.

**Q. DOES THE AGREEMENT REFLECT ANY UNDERLYING THEME FROM THE NEGOTIATIONS?**

A. Yes. The Agreement reflects a combination of balance and practical reality, which was present throughout the negotiations. Section 1.16 of the Agreement describes the balance that the Signatories believe results from the Agreement, ranging from investments in Arizona's energy future, to benefits to low income customers, to new rate options. Importantly, the rate-related benefits to APS are intended to permit an improvement in the Company's ability to attract capital, maintain reliability, and sustain growth—benefits that are as important for the future of both the Company and our customers as any of the other provisions of the Agreement.

I personally participated in all of the formal negotiation sessions. I can attest that, when roadblocks or challenges arose, the parties looked for creative ways to resolve issues, and thus preserve the careful equilibrium the Agreement achieves. Additionally, the parties remained acutely aware throughout the course of the settlement process of the Commission's role in approving the Agreement and setting the Company's rates, and considered and evaluated proposals with that in mind. In this regard, individual Commissioner interests as expressed in letters or as ascertained from other matters pending at the Commission were given high priority and actively discussed by the parties.

Significantly, because the settlement process allowed important policy issues to be vetted outside a formal adversarial process, conflicting viewpoints regarding those issues were resolved efficiently, expediently, and creatively compared to how they might have been addressed in litigation. I believe the resulting Agreement is a carefully crafted and cooperatively achieved balance of many important interests, not just those of APS. However, the balance that was achieved by the Agreement is a delicate one—many aspects of the Agreement reflect the limits to which APS was able or willing to agree, and in many cases APS could only agree to a provision dependent upon the presence of other provisions in the Agreement.

Taken as a whole, I believe the Agreement advances many policy interests important to Arizona and its residents. For APS, that includes those of our customers, our employees, our shareholders, our environment, and our communities alike. It also reflects the Commission's expressed policy objectives in the areas of energy efficiency, renewable energy, rate stabilization, demand response and treatment of low income customers, as well as the

Commission's previously expressed expectations of APS in the areas of cost management and efficient operations. As a result, I firmly believe that the Agreement presented to the Commission is in the public interest and should be approved.

**Q. WHAT STANDARD DO YOU BELIEVE THE COMMISSION SHOULD USE IN EVALUATING THE AGREEMENT?**

A. The same general public policy supporting settlement of contested matters in civil litigation also applies to utility rate cases. However, a rate case settlement is not a resolution solely between private litigants. In contrast, it must result in just and reasonable rates and the Commission must conclude that the settlement is in the public interest. The evidentiary record in this case is presented by both the Direct Testimony and rate case application of APS, and the Direct Testimony of Staff and intervenors, in addition to the Agreement itself and the Testimony being filed in support of the Agreement. APS believes that the record in this case amply supports approval of the Agreement.

IV. <u>SETTLEMENT TERMS</u>

**Q. PLEASE GENERALLY DESCRIBE THE TERMS OF THE AGREEMENT.**

A. To APS, each of the terms of the Agreement is intended, to one degree or another, to be forward-looking and to promote Arizona's energy future. Some do so expressly, such as the provisions establishing new energy efficiency programs and commitments, renewable energy resource goals for APS, and the commitment to implement demand response programming designed to send appropriate price signals to customers, encouraging them to conserve energy during times of peak consumption. But other terms are equally important in promoting Arizona's energy future, such as the proposed revenue requirement and other provisions relating to APS's financial condition. These latter terms reflect the fact that only a financially healthy APS will be able to meet its customers' future energy needs and implement the commitments made within the rest of the Agreement. Mr. Hatfield describes the Company's vision of its role in creating a sustainable energy future for Arizona, and the importance of improving APS's financial condition to achieve that vision. Like Mr. Hatfield, I believe that this Agreement takes a critical step towards that important goal.

*A. The Settlement Framework*

**Q. PLEASE DESCRIBE THE GENERAL FRAMEWORK OF THIS SETTLEMENT.**

A. As previously discussed, the Agreement achieves a balance of stakeholder interests. To APS, this is reflected both within certain terms individually and within the entire document collectively. For example, the "General Rate Case Filing Plan" contained in Section II is balanced by the level of rate increase as well as by related provisions. These related provisions include the treatment of APS's Schedule 3 proceeds as revenue, the deferral of certain pension and other post-retirement benefit ("OPEB") costs, and a change in the depreciation rates for the Palo Verde Nuclear Power Plant ("Palo Verde") upon approval of a license extension request. Each of these provisions was essential for APS to agree to wait until at least mid-2012 before implementing any new base rates, and to agree to the rate increase reflected in the Agreement, without jeopardizing the Company's financial health.

The financial framework of the Agreement also contains provisions other than higher rates to improve APS's financial profile. For example, the Agreement includes a requirement that APS reduce its operating expenses by an average annual $30 million for each year of the 2010 to 2014 plan term ("Plan Term").

This requirement complements and expands on the Commission's requirement that APS reduce its 2009 expenses by $20 million in the interim rate order. Additionally, APS has committed to equity infusions of at least $700 million from the date of the Agreement through the end of the Plan Term to maintain or improve its financial ratios.

Another important provision of the Agreement is intended to provide information to the Commission on APS's operational and cost-management performance through a third-party benchmarking analysis (at the Company's expense) to support the Commission's review of the 2011 rate case. The benchmarking analysis will report on a host of performance indicators. In addition to the benchmarking analysis, the Agreement includes a series of "Performance Measurements" intended to reflect the alignment of APS's management practices with policy objectives of the Commission.

A final important balance was addressing the challenge of the ROE authorized in the Settlement with the realistic ROEs that APS could achieve during the first three years of the Plan Term. This is particularly important when considered alongside the commitments that APS has agreed to regarding energy efficiency, renewable energy, low income programs and other provisions in the Agreement (which I will also later summarize). From 2010 through 2012, APS's <u>earned</u> ROE will be significantly less than the 11% authorized ROE in the Agreement and APS's actual cost of capital, as Mr. Hatfield describes in his Direct Testimony. Nevertheless, as Mr. Hatfield also indicates, APS believes that, taken as a whole, the Agreement provides a critical opportunity for all stakeholders to continue to work together to improve APS's financial performance and to pave the way for a sustainable energy future for Arizona.

**Q. YOU REFERRED TO SEVERAL OF THE AGREEMENT'S PROVISIONS IN YOUR PREVIOUS ANSWER. PLEASE PROVIDE A BRIEF DESCRIPTION OF EACH.**

A. Certainly. I will discuss each of the provisions as they appear chronologically in the Agreement (bypassing the Recitals in Section I). Section II sets forth the "Rate Case Stability Provisions," which includes both a Rate Case Filing Plan and a provision requiring APS to accelerate any refund to customers that would result from an over-collected balance in the Power Supply Adjustor ("PSA") at the time new rates are implemented.

The former provision, the Rate Case Filing Plan, contains a number of key terms. First, it establishes a rate case schedule that precludes APS from filing more than two rate cases during the Plan Term: the first not earlier than June 1, 2011 (using a Test Year end date of no earlier than December 31, 2010) and another no earlier than June 1, 2013 (using a Test Year end date of no earlier than December 31, 2012). Under this Plan, customers would not see another APS base rate increase before July 1, 2012—three years from now. In addition, recognizing the importance of the interval between these two subsequent rate case filings to the Signatories, APS agreed to meet and confer regarding an appropriate test year and filing date for the second anticipated rate case if the first case in the schedule is not resolved by July 1, 2012.

Importantly, the Rate Case Filing Plan outlines a series of tools designed to improve the efficiency of the rate case process for future APS rate cases. One objective of this provision is to allow the next case to be processed within 12 months of a sufficiency finding, but it is also targeted at reducing the overall workload and time spent on such cases for all parties by introducing process improvements. Specifically, APS is required to notify the Commission and the

Signatories of its intent to file a rate case 120 days before it is permitted to file, using a "notification filing" that indicates, among other things, when APS plans to file the rate case application, the proposed effective date of the resulting rates, and any major issues that APS expects to raise in the application. Sixty days after such notice is filed, the Signatories are required to meet and confer in attempt to narrow the issues presented in the filing, streamline the processing of the application process, and identify a set of data requests to which APS will respond as part of its initial filing.

With respect to the PSA refund acceleration, when fuel prices are relatively low, as they are currently, it is possible that the PSA can result in an over-collection of total fuel and purchased power costs. Although these costs could be higher than forecast this summer, APS currently expects to have such an over-collection in its PSA account for 2009. Under the PSA Plan of Administration, an over-collection is refunded as a credit to customers when the PSA is reset in February of each year. Under the Agreement, any refund owed to customers would be credited to the PSA rate at the same time that the rate increase resulting from this case becomes effective, resulting in a lower total increase when rates are implemented.

Q. **PLEASE DESCRIBE THE RATE INCREASE AND RELATED FINANCIAL PROVISIONS THAT THE AGREEMENT PROVIDES IN RESOLUTION OF THIS RATE CASE.**

A. Negotiating financial provisions that were acceptable to the Signatories and that allowed APS to retain a minimum level of financial health was extremely challenging. From APS's perspective, all of the Signatories were creative in crafting a balanced outcome. The Agreement provides for a base rate increase of $131.1 million over the interim increase of $65.2 million that was previously approved by the Commission in Decision No. 70667. Combined, this results in a total non-fuel base rate increase of $196.3 million. Recognizing the challenges posed by a historical test year to APS's financial condition during periods of significant capital investment in needed facilities, this increase includes consideration of post-test year plant through June 30, 2009. The agreed-upon increase also reflects the Signatories' "desire to enhance APS's ability to retain and improve its current investment grade credit rating, thereby enabling APS to attract capital at reasonable cost, and also to optimize its operational flexibility, in order to be better positioned to meet its customers' future energy needs." Section 3.4.

With respect to fuel costs, the Agreement updates the base cost of fuel and purchased power to $0.037571 per kWh, which is an increase of $0.005080 per kWh from the current base fuel and purchased power level of $0.032491, as provided for in the PSA Plan of Administration. This results in reclassifying $137.2 million of fuel and purchased power costs currently collected in the PSA as base rates, as well as an additional $11.2 million of annual revenues because the 90/10 sharing provision of the PSA does not apply to base fuel and purchased power costs. Under the Agreement, APS will continue that 90/10 sharing arrangement for the PSA until at least the next rate case, even though this provision is not contained in the fuel adjustment clause of any other electric utility in Arizona.

For ratemaking purposes, the Signatories agreed to a capital structure of 46.21% debt and 53.79% of common equity, and adopted an embedded cost of debt of 5.77% and an authorized ROE of 11.0%. The 11% authorized ROE is somewhat higher than the 10.75% allowed ROE currently set for APS, but is the same

ROE as proposed by Staff in its Direct Testimony and is less than that requested by APS in its original rate filing. Moreover, as Mr. Hatfield explains in detail, the financial provisions of this Agreement are not sufficient to allow APS to actually earn the 11% authorized ROE between now and when rates are next adjusted.

Consistent with Staff's initial proposals, the Agreement adopts the depreciation and amortization rates contained in the Direct Testimony of APS Witness Dr. Ronald White in the underlying rate case, but not APS's proposed change to the depreciation rate for electronic meters. The Signatories also agreed to a fair value rate of return of 6.65%, including a fair value increment.

Collectively, the rate increase provided in the Agreement results in a base rate increase of approximately 7.9%. Some of that increase is already reflected in the interim rates authorized in Decision No. 70667. Net of those interim rates, the Agreement proposes a 5.4% increase over the current level of base rates.

**Q. WHAT OTHER PROVISIONS IN THE AGREEMENT ARE INTENDED TO IMPROVE APS'S FINANCIAL CONDITION?**

A. As I mentioned previously, the base rate increase contained in the Agreement was not itself sufficient to maintain APS's financial health between January 1, 2010 and the next permitted adjustment of base rates in mid-2012 or later. In an effort to balance the goal of keeping base rates as low as possible, particularly in a difficult economic climate, with APS's need to improve financial performance, the Agreement includes additional creative mechanisms to address APS's financial requirements outside of a base rate increase. These include revenue treatment for Schedule 3 proceeds, the deferral of certain pension and OPEB costs, and a depreciation rate change reflecting an anticipated license extension at Palo Verde. Each of these additional provisions is very material to APS's financial condition and all of these provisions improve the Company's earned ROE and other metrics without increasing the base rates in this case. I will discuss each of these in turn.

### 1. Revenue Treatment of Schedule 3

The Agreement allows APS to record the proceeds it receives under Schedule 3 as "revenue" rather than as "Contributions in Aid of Construction" for accounting purposes from January 1, 2010 through the earlier of either December 31, 2012 or the conclusion of the Company's next general rate case. Importantly, this revenue accounting treatment does not change the amount of money collected from applicants under Schedule 3—the Agreement proposes that customers still pay the costs of interconnecting to APS's system as the Commission previously ordered. However, such accounting treatment results in estimated additional revenues of $23 million in 2010, $25 million in 2011, and $49 million in 2012. Without the increasing trend in estimated revenues between 2010 and 2012, APS would either have needed its next base rate increase sooner or a higher level of initial increase on January 1, 2010.

The letters from Commissioners regarding Schedule 3, and particularly the "free footage" provisions applicable to single residential customers in earlier versions of Schedule 3, were discussed at length during settlement talks. The Agreement ultimately did not propose to change the Commission's current policy of requiring customers seeking new or expanded service to pay for the costs of extending such service. However, because the revenue treatment of the proceeds from Schedule 3 is critical in the overall financial framework of the Agreement until the end of 2012, APS has submitted information on the revenue impacts associated with various free footage scenarios. The Company believes that the most appropriate way to address this issue is to allow the hook-up fee docket to continue its generic review on the policy of line extension costs, and if there is still a desire to change the current policy and return to either a free footage or equipment allowance, to do so in the 2011 APS rate case. However, if such a policy were to be adopted in this case, there would need to be a compensatory adjustment to offset the revenue impacts in 2010 through 2012 and still preserve the financial framework of the Agreement.

Mr. Rumolo describes the Agreement's treatment of Schedule 3 in greater detail in his testimony, including process improvements in the administration of Schedule 3 that will benefit customers.

**2. Adjustment of Depreciation Rates for Palo Verde License Extension.**

APS, on behalf of all Palo Verde participants, submitted an operating license renewal application with the Nuclear Regulatory Commission ("NRC") in December 2008 for the three units at Palo Verde Nuclear Generating Station. If approved after an approximately two year process, the operating license for each unit would be extended by 20 years. This would, in turn, reduce the depreciation expense related to those assets because the remaining amount of plant needing to be recovered through depreciation expense could be recovered over a longer period of time.

Reducing depreciation expense improves earnings for APS without increasing rates. Thus, as a non-cash method of supporting the Company's financial viability without increasing the level of base rates in this case, the Agreement authorizes APS to implement these lower depreciation rates upon the later of January 1, 2012, or when the license extension is granted by the NRC. This provision is expected to reduce APS's depreciation expense by approximately

$34 million in 2012 on an ACC-jurisdictional basis, which will improve APS's earned return in 2012 without requiring higher base rates in this case.

The other significant rate impact of license extension is on the funding levels required for APS's Nuclear Decommissioning Trust Fund. The Nuclear Decommissioning Trust Fund collects the costs required to decommission Palo Verde from customers through a combination of the System Benefit Charge ("SBC") component of base rates and the PSA. If the license of Palo Verde is extended, the NRC's required level of funding for the Decommissioning Trust Fund will decrease because there will be more time to collect the funds necessary to decommission the units. Thus, to provide that benefit to customers prior to the Company's next general rate case, APS will request a rate reduction of the SBC to reflect lower funding requirements for the Nuclear Decommissioning Trust Fund to be effective January 1, 2012. The amount of those decommissioning funds collected from customers under the PSA will also be reduced to reflect a reduction in Independent Spent Fuel Storage Installation costs resulting from the license extension.

However, unlike depreciation expense, which looks only at plant lives, the specific reductions to the SBC and PSA depend on a number of variables such as the performance of investments in the trust funds, inflation assumptions and decommissioning cost estimates. These assumptions will change by the time this provision is implemented in 2012. However, based on current reasonable assumptions regarding inflation rates and the investment portfolios of the Nuclear Decommissioning Trust Fund, a rate reduction of between $10 million and $20 million would be reasonable to expect. APS will make the request to reduce the SBC in sufficient time to allow the Commission to reduce the SBC simultaneously with the implementation of new depreciation rates, and the PSA portion would adjust in February 2012.

**3. Pension and OPEB Deferrals**

Another element that supports the Company's financial metrics under the rate case schedule is the provision that allows APS to defer for future recovery pension and OPEB costs incurred in 2011 and 2012 above the Test Year level, subject to certain capped amounts set forth in Section IX of the Agreement. Because of market conditions since the 2007 Test Year, pension and OPEB expenses have increased dramatically and are expected to remain at higher levels in upcoming years. Allowing the Company to record amounts prudently incurred above Test Year levels as a regulatory asset for recovery in the next rate case improves the earned ROE in 2011 and 2012—taking an important step to improving the Company's financial metrics—without increasing the level of rates implemented in 2010. The Pension and OPEB costs at issue do not include costs relating to the Company's Supplemental Excess Benefit Retirement Plan ("SERP"), and the recovery of these non-SERP pension and OPEB costs has not been contested in this or prior APS rate cases. The Agreement also allows for the review these deferrals in APS's next rate case for reasonableness, prudence, and the appropriate amortization period.

Q. **YOU PREVIOUSLY INDICATED THAT THERE ARE PROVISIONS OTHER THAN HIGHER RATES IN THE FINANCIAL FRAMEWORK OF THIS AGREEMENT. PLEASE EXPLAIN.**

A. As I mentioned, the financial results of this Agreement for APS were necessary to allow APS to agree to the rate case stability plan and schedule described above and meet the other numerous obligations in the Agreement. But the financial provisions of the Agreement contain more than just higher rates by also focusing on the Company's operational performance and cost efficiency.

For example, Section VII requires APS to implement annual expense reductions of an average $30 million per year (with a minimum floor of $25 million) each year throughout the Plan Term, for a total reduction of $150 million. As I noted earlier, this provision complements and expands the similar cost reduction requirement ordered for 2009 by Decision No. 70667. Expense reductions of this magnitude will not be easy to achieve without adversely affecting reliability and service quality, particularly given the significant cost reductions APS already has made in the last several years. APS undertook this commitment in acknowledgment of the fact that it must operate as efficiently as possible to improve its financial condition.

Also, the Agreement contains a provision requiring $700 million of equity infusions at APS between now and the end of 2014. The objective of these infusions is to allow APS to maintain investment grade financial ratios and a balanced capital structure, while making the major capital investments necessary to promote a sustainable energy future for our customers. The ability to meet these commitments absolutely depends on APS being granted the financial treatment afforded by the Agreement. As Mr. Hatfield explains in his testimony, equity investors will not buy Pinnacle West stock unless they believe that they are likely to receive a reasonable return on their investment both in the immediate future and over the long term. More specifically, APS issued debt while this case was pending, and knew that debt investors were requiring an 8.75% return to invest in APS or Pinnacle West. Thus, in evaluating the financial provisions of the Agreement, APS needed to be able to earn ROEs for equity investors that were better than the returns paid to debt investors for the 2010-2012 timeframe. Investors do not care about authorized ROEs, and would be looking at what ROE APS or Pinnacle West could actually earn in deciding whether to make an equity investment. Without higher earned ROEs, equity investors may not make the investments necessary to raise equity capital. Equity investors are not required to make an investment, and there are many other electric utilities that are competing for these investors' capital. Many of the financial provisions of the Agreement are focused on addressing this challenge.

Finally, the Agreement contains a series of provisions intended to provide an objective analysis of the Company's operational performance and cost management practices compared against both its industry peers and a set of stipulated "Performance Measurements." The Agreement requires APS to fund a comprehensive benchmarking analysis of the Company's operations, in which a Staff-selected benchmarking firm will analyze APS's cost and operational performance across numerous areas (Section 13.7) and compare the Company's performance to a peer group of other investor-owned, electric utility operating companies. A "Benchmark Study Report" will be submitted to the Commission no later than December 31, 2010, discussing the benchmarking firm's conclusions about the Company's performance and identifying areas where that performance appears to be significantly above or below the norm. This information will thus be available to the Commission when considering the Company's next rate case.

Section XIII of the Agreement requires APS to undergo periodic performance evaluations throughout the Plan Term, and creates two mechanisms for the Commission's use in doing so. First, it establishes a detailed list of "Performance Measurements" (Section 13.2), which allows the Commission to annually evaluate the Company's performance under certain key aspects of the Agreement including compliance with the expense reduction provision, compliance with the Implementation Plans designed to meet the energy efficiency and renewable energy targets (described below), and compliance with the equity infusion provision. As described in Section XII, if APS does not achieve the Performance Measurements applicable to the year in which the Company is evaluated, or fails to secure a hardship waiver from the Commission from meeting the Measurement, the Company will not seek recovery of any costs above test year levels for the Annual Cash Incentive Compensation paid to APS Executives, even if those higher incentive levels were prudent and reasonable. APS believes that this provision of the Agreement reserves the necessary management discretion of the Compensation Committee of APS's Board of Directors, while still aligning management objectives with Commission policies.

In addition to the Performance Measurements, the Agreement also commits APS to extensive reporting requirements for a comprehensive list of customer service, reliability, safety, and financial information. This information includes: the frequency and duration of unplanned outages; the number of calls from customers and the level of customer satisfaction regarding how those calls were handled; the frequency and severity of employee injuries; changes to employee headcounts; levels of enrollment in energy efficiency programs; the Company's earned ROE and FFO/Debt ratio and the major factors that impacted those metrics; the price and net book value of Pinnacle West stock; any equity and long-term debt issuances made; the criteria used by the Board to measure performance for the purpose of determining incentive awards; and other various matters. APS must also submit an annual report documenting its performance for the preceding year in relation to the Performance Measurements described above.

Collectively, these provisions provide the Commission with a host of tools to assess the Company's performance in a variety of areas. APS views this Agreement and the Plan Term as an opportunity to continue to engage in open discussions with the Commission, our customers, and other stakeholders about the Company, its vision, our costs, and the necessary support APS will need to allow it to continue down the path begun by this Agreement and create a sustainable energy future for our state.

*B. Energy Efficiency*

**Q. PLEASE BRIEFLY DESCRIBE THE PROVISIONS RELATING TO ENERGY EFFICIENCY.**

A. The energy efficiency or Demand Side Management ("DSM") provisions, contained in Section XIV of the Agreement, set forth several initiatives aimed at increasing energy efficiency for all customer classes throughout the APS service territory. Among other things, the Agreement (1) sets energy efficiency goals for APS for the 2010 to 2012 period, complimented by modifications to the existing performance incentive to encourage achievement of those goals at higher levels; (2) requires APS to file an Energy Efficiency Implementation Plan for the Commission's approval, including several specific new or expanded programs to achieve the Agreement's energy efficiency goals; (3) allows large commercial or large industrial customers to "self direct" DSM programming, under specific parameters; and (4) modifies the Company's Demand Side Management Adjustment Clause ("DSMAC") to better match expenditures and cost recovery similar to the clause the Commission recently approved for Tucson Electric Power ("TEP"), and requires APS to pay interest to customers for any over-collected balance on the DSMAC account without receiving interest on under-collected amounts. Many of these new programs will be aimed at increasing energy efficiency measures for schools, municipalities, residential, and low-income customers. Also, under the Agreement, APS will not recover its unrecovered fixed costs associated with the decreased energy usage resulting from DSM programming in this rate case. APS Witness James Wontor describes these provisions in detail in his Direct Testimony.

Q. **HOW DO THE ENERGY EFFICIENCY GOALS ESTABLISHED IN THE AGREEMENT INTERPLAY WITH THE ENERGY EFFICIENCY RULEMAKING CURRENTLY IN PROCESS AT THE COMMISSION?**

A. The Agreement was specifically designed to require APS to either meet or exceed any other energy efficiency goals adopted by the Commission. Section 14.1 notes that if <u>higher</u> energy efficiency goals are adopted by the Commission in another docket for 2010 through 2012, those goals would supersede the targets set forth in the Agreement. On the other hand, if any <u>lower</u> goals are adopted, APS would still be required to comply with the more stringent levels established in the Agreement. In other words, the Agreement sets forth the <u>minimum</u> targets for the Company for energy efficiency.

*C. Renewable Energy*

Q. **PLEASE BRIEFLY DESCRIBE THE PROVISIONS RELATING TO RENEWABLE ENERGY.**

A. The Renewable Energy provisions, set forth in Section XV of the Agreement, require APS to take a series of actions intended to support the Company's acquisition or installation of renewable resources through December 31, 2015. The underlying goal of these provisions is for roughly 10 percent of the Company's total retail energy sales to come from renewable resources by that date—an early, significant, and important milestone in marking the path forward towards a sustainable energy future for our customers. These renewable resource provisions, coupled with the improved financial support for APS, are critical steps toward realizing such a future and in moving beyond mere plans to actual projects. In this case, the Agreement reflects a commitment to acquire 1.7 million MWh of renewable energy resources by 2015.

The Agreement does not mandate any specific level of commitment by APS in the year 2025, nor does APS believe such a requirement would be appropriate in isolation of other elements in the Agreement. It is one thing to develop commitments and programs for the next five years. However, over the next 15 years, there will be changes in technology, markets, costs, and lessons learned that are impossible to anticipate today. APS believes that it is most important to get the trajectory right early in the process, and recognize that changes to specific requirements will likely be prudent and necessary as one moves farther into the future.

As to specific programs, the Agreement requires APS to issue requests for and seek Commission approval of projects for in-state wind generation, to file a plan to implement a utility-scale photovoltaic generation project (distinct from the Solana and Starwood Concentrated Solar Power projects previously submitted to the Commission); prioritize and commence permitting, engineering and thereafter construction of one or more transmission projects to facilitate interconnection of renewable resources to Arizona's transmission system; file a new program for on-site solar energy at schools with a program goal of 50,000 MWh of annual energy generation or savings; and file a program for distributed solar energy for governmental institutions that either substantially reduces or eliminates up-front costs. In addition, the Agreement supports APS investment in renewable projects if appropriate by allowing APS to recover the capital carrying costs of any capital investments made by APS in such projects through an appropriate adjustment mechanism (such as the PSA) or the Renewable

Energy Surcharge ("RES"). APS Witness Barbara Lockwood describes the Agreement's specific renewable provisions in greater detail.

**Q. PLEASE DESCRIBE HOW THE PROVISIONS RELATING TO RENEWABLE ENERGY INTERPLAY WITH THE RENEWABLE ENERGY STANDARD TARIFF AND RULES ("RES RULES").**

A. The terms of the Agreement commit APS to undertaking projects at levels that exceed the minimum requirements of the RES Rules, and specifically require APS to abide by those commitments regardless of the outcome of any judicial challenge to those rules, which would include the current lawsuit brought by the Goldwater Institute. In the Agreement, APS also reiterates and renews its commitment to the RES Rules (Section 15.8)—a commitment that I believe is underscored by the magnitude of renewable energy projects APS has agreed to undertake. As indicated previously, the new renewable resource commitments in the Agreement, in combination with existing renewable energy commitments, puts APS on a trajectory that exceeds the RES requirement and clearly demonstrates the Company's commitment to renewable energy regardless of what happens with any challenge to the RES Rules.

**Q. PLEASE DESCRIBE THE RENEWABLE TRANSMISSION PROVISIONS OF THE AGREEMENT.**

A. In the Agreement, APS commits to permitting, engineering and constructing one or more projects required by the Biennial Transmission Assessment report (*see* Decision No. 70635). These projects will facilitate the interconnection of renewable resources to Arizona's transmission system. This is significant because it represents not just a benefit to APS and our customers in obtaining enhanced access to such renewable resources, but is also intended to create a supportive environment to the developers of renewable resources, whether they ultimately produce energy for Arizona or for others in the Southwest. A sustainable future for Arizona will ultimately require more than just specific projects for APS, but rather an overall environment supportive of renewable resources, and this provision is intended by APS to promote that environment.

*D. Low Income Customers*

**Q. THE AGREEMENT CONTAINS SEVERAL PROVISIONS RELATING TO LOW INCOME CUSTOMERS. PLEASE BRIEFLY DESCRIBE THE BENEFITS OF THE AGREEMENT TO THESE CUSTOMERS.**

A. The Low Income Program provisions, contained in Section XVI of the Agreement, are targeted at both current and future low income customers. Among other things, the low-income provisions of the Agreement (1) shield low income customers (both current and those to be enrolled in the program) from a base rate increase as a result of this rate case; (2) require APS, at its own expense, to augment by $5 million its current bill assistance program to offer identical assistance to customers whose incomes exceed that 150% level of the Federal Poverty Income Guidelines but are less than or equal to 200%; (3) require APS to waive the collection of an additional security deposit from customers on low income rate schedules under qualifying circumstances; and (4) continue the exemption of qualifying low income customers from the DSMAC charge that was established by this Commission in Decision No. 70961. Mr. Rumolo will describe these provisions in greater detail in his Direct Testimony.

*E. Provisions Relating to Demand Response and Other Rate Matters*

**Q. THE AGREEMENT CONTAINS SEVERAL PROVISIONS RELATING TO DEMAND RESPONSE PROGRAMMING AND OTHER RATE MATTERS. PLEASE BRIEFLY DESCRIBE THOSE REGARDING DEMAND RESPONSE.**

A. The Demand Response provisions, contained in Section XX of the Agreement, establish several terms aimed at encouraging customers to conserve energy during periods of high consumption. Among other things, Section XX recommends that the Commission approve the new demand response super peak time-of-use rate, described in detail in the Direct Testimony of Charles Miessner in the Company's original rate case application. If approved, APS would offer that rate on the effective date of this rate increase. The Agreement also requires APS to implement two critical peak pricing programs (one for residential customers and one for commercial customers) on a pilot basis. Both of these programs and other matters contained in Section XX are described in the Direct Testimony of Mr. Rumolo supporting the Agreement.

**Q. PLEASE BRIEFLY DESCRIBE ANY OTHER RATE SCHEDULE MATTER PROVISIONS.**

A. Section XXI of the Agreement contains provisions for all other rate schedule matters, including a requirement that APS unfreeze the existing House of Worship Rate Schedule for a period of 12 months to allow for additional customer participation. It also requires that APS file a new optional time-of-use rate applicable to K-12 schools, designed to provide daily and seasonal price signals to encourage schools to reduce energy usage during peak periods. Mr. Rumolo describes these new rate offerings in his testimony.

## V. <u>CONCLUSION</u>

**Q. DO YOU HAVE ANY CONCLUDING REMARKS?**

A. APS appreciates the commitment of all of the parties in working diligently during over four months of negotiations to achieve a settlement of a complex rate case addressing such a wide range of important policy issues and with a level of rate increase that could be supported by all classes of APS customers. Many of the commitments in the Agreement represent critical steps towards achieving a sustainable energy future for Arizona. However, such a future requires more than just the identification of different renewable energy projects, or a desire to increase energy efficiency, or the construction of new transmission lines. A sustainable energy future means billions of dollars of investment by APS over the next few years. Such a level of investment, no matter how worthwhile or important, simply cannot be made if APS is not financially healthy and well positioned to raise the debt and equity capital necessary for such investments. Although the financial provisions and rate case stability provisions in the agreement were minimally adequate for APS, and were coupled with numerous APS commitments that could not have been imposed outside of a settlement, they are no less important to achieving a sustainable energy future than any specific project or program in the Agreement.

The widespread support for the Agreement by parties who spent over four months in detailed discussions is probably the best evidence that it is in the public interest. While settlements of rate cases are not unusual in the United States, settlements with such widespread support from such diverse interests are uncommon. The future of the electric utility industry, with climate change legislation, massive resource commitments, national competition for investment capital, and changing laws and regulations will be challenging for everyone. Approving this Agreement, however, puts APS and our customers on a path from which a reasonable future can be reached. I believe that this Agreement, on balance, results in just and reasonable rates for our customers and is in the public interest. I urge the Commission to approve the Agreement.

**Q. DOES THIS CONCLUDE YOUR DIRECT SETTLEMENT TESTIMONY?**

A. Yes.

# DIRECT SETTLEMENT TESTIMONY OF JAMES R. HATFIELD

## On Behalf of Arizona Public Service Company

## Docket No. E-01345A-08-0172

July 1, 2009

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**DIRECT SETTLEMENT TESTIMONY OF JAMES R. HATFIELD ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY (Docket No. E-01345A-08-0172)**

I. INTRODUCTION

**Q. PLEASE STATE YOUR NAME, ADDRESS, AND OCCUPATION.**

A. My name is James R. Hatfield. My business address is 400 North 5th Street, Phoenix, Arizona, 85004. I am Senior Vice President and Chief Financial Officer of both Arizona Public Service Company ("APS" or "Company") and Pinnacle West Capital Corporation ("Pinnacle West"). I have executive management responsibility for the financial affairs of the Company, including all aspects relating to accounting, finance, taxes, budgeting and financial planning, and investor relations.

**Q. WHAT IS YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND?**

A. I have a Bachelor of Science degree with a functional major in accounting from Central Missouri State University and an M.B.A. degree from the University of Missouri-Kansas City. I have 28 years of experience in the utility and energy business. I joined APS and Pinnacle West in my current capacity in July 2008. Immediately prior to that time, from August 1994 until July 2008, I worked at OGE Energy Corp. ("OGE"), the parent company of Oklahoma Gas and Electric Company. While at OGE, I served in various roles, including Treasurer from August 1994 until January 1996, Vice President and Treasurer from January 1996 until November 1999, and Senior Vice President and Chief Financial Officer from November 1999 until July 2008. Before OGE, I worked in various accounting and finance roles at UtiliCorp United Inc. of Kansas City, Missouri from 1980 through 1994, and served as UtiliCorp's Assistant Treasurer from

1988 to 1993. From January through August of 1994, I also held the position of Vice President, Investor Relations and Corporate Secretary for Aquila Gas Pipeline Corporation of San Antonio, Texas, a publicly traded subsidiary of UtiliCorp United Inc.

**Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

A. My testimony will focus on the financial results underpinning the settlement agreement ("Settlement Agreement" or "Agreement") reached by the many parties who participated in settlement discussions in this docket (the "Signatories"). In addition, I will discuss why APS agreed to the provisions in the Settlement Agreement and the considerations that must be made going forward to enable the Company to help implement a proactive energy policy and realize its vision of creating a sustainable energy future for the State of Arizona. The specific terms of the Agreement are discussed in the testimonies of APS Witnesses Jeff Guldner, David Rumolo, Jim Wontor, and Barbara Lockwood.

## II. SUMMARY

**Q. PLEASE SUMMARIZE YOUR TESTIMONY.**

A. This case is about the future of energy in Arizona and the investment required not only to maintain safe and reliable service for APS customers but also to provide APS with the necessary means of implementing a sustainable energy policy for the State. APS takes its role in providing for Arizona energy's future quite seriously. Indeed, the Company's business model has at its core a vision of "creating a sustainable energy future for Arizona" – one that brings long-term benefits to the State's environment, economy, and communities.

APS is the largest electric utility in the State of Arizona and, as I will describe, has a statewide presence and influence. As such, APS's financial health is critical to help the Commission implement a forward-looking, sustainable statewide energy policy. To be "sustainable," however, such a policy must not only support the strategies and business practices that provide the foundation for a healthy environment, vibrant economy, and strong community. It must also allow APS to meet its basic business needs – including the ability to actually earn a reasonable rate of return – while investing in the resources necessary to achieve those important goals.

The Settlement Agreement reached in this case takes a critical step in the right direction. Significantly, it represents the hard work and impressive alignment of the often-disparate interests of the many Signatories – a fact that the financial community understandably views as supportive of Arizona's regulatory environment. The Agreement also buttresses the Company's financial condition in the short term and contains various provisions – including a rate case cycle and rate case process improvements – that can be a starting point for implementing other mechanisms that will reduce the impact of regulatory lag in between rate cases and improve the Company's financial condition in the long run.

But although APS believes that the Settlement is a positive step toward improvement, it still provides no more than the minimal level of rate relief APS needs to support investment grade financial metrics and allow the Company to continue providing reliable electric service at reasonable prices. Even in the short run, before the allowed effective date of rates from APS's next rate case under the proposed rate schedule, the revenue requirement contained in the Agreement allows for only marginal financial metrics. APS will still significantly under-earn its cost of equity capital during this initial period, projecting ACC-Jurisdictional returns on equity ("ROE") of only 9.4% in 2010, 8.4% in 2011, and 8.1% in 2012 – far below both APS's current authorized ROE of 10.75% and the Agreement's proposed ROE of 11%, and below even the 8.75% return APS investors required on the Company's recent debt issuance (a much less risky investment, for which investors would expect and require a lower return compared to equity investment).

Moreover, although the additional revenue that APS will receive under the Agreement as proposed combined with the required expense reductions is projected to support APS's Funds from Operations to Debt ("FFO to Debt") ratio at current BBB- investment grade levels in 2010 (at 18%), that level is the **very cusp** of the 18% threshold into non-investment grade. There is no margin remaining to hedge the impact of unexpected events that may drive that metric down into junk levels. For the later years, APS projects that its FFO to Debt ratio will fall below that 18% threshold even under the Agreement as proposed, to 17.6% in 2011 and 17.9% 2012.

For purposes of this Settlement, APS accepts the significant challenges presented by these marginal figures, but emphasizes that there is no room for further degradation in the Company's financial metrics without placing the Company at a real and material risk of downgrade. Simply put, it is critical to APS's financial condition, the viability of this Settlement, and a robust energy future for this State that the Company receives the full amount of the increased revenue and other financial supports proposed in the Agreement. To the extent the Commission makes any change to the Agreement's provisions, such change must be revenue- and financially-neutral to the Agreement. In sum, APS envisions a future of working with the Commission to create a sustainable energy future for Arizona, but currently lacks the resources and tools it needs to do so. APS is not alone in its need for base rate increases – utilities nationwide share that need in their respective efforts to meet the many policy and other challenges facing electric utilities today. What is different regarding APS is the lack of sufficient mechanisms to reduce the impact of regulatory lag and maintain the Company's financial condition in between rate cases. Such tools will allow APS and the Commission to avoid the distraction of a constant string of rate cases, focusing instead on putting in place the important policies that will shape this State's energy future. The Settlement Agreement is a crucial first step toward this important goal.

## III. APS'S VISION OF SUSTAINABILITY

**Q. PLEASE DESCRIBE THE COMPANY'S VISION OF SUSTAINABILITY.**

A. As I previously indicated, APS is committed to working with the Commission and other stakeholders to create a sustainable energy future for the State of Arizona. To APS, this vision means devising and implementing policies and practices that deliberately address environmental stewardship, economic vitality, and community/customer prosperity, and that continually challenge all stakeholders to act now in ways that provide the building blocks for a better future. Importantly, such policies must also provide for a financially healthy APS – one that is able to meet its basic business needs while still investing in the resources necessary to achieve the other elements of what will make Arizona's energy future a truly sustainable one.

**Q. HOW CAN APS HELP SHAPE ARIZONA'S FUTURE ENVIRONMENT, ECONOMY AND COMMUNITIES?**

A. APS is Arizona's largest and longest serving electric utility, serving Arizona's growing population since 1886. APS serves more than 1.1 million retail and wholesale customers in all or part of 11 of Arizona's 15 counties – a service territory of approximately 35,000 square miles. With an extensive network of power plants, transmission and distribution lines, offices and support facilities, APS is the largest property taxpayer in the State by a significant margin, infusing $119 million of property tax in 2008 in the vast areas that the Company serves, and more than **doubling** the tax payment of Salt River Project, Arizona's second largest taxpayer.

With 7,200 employees and another 1,152 contractors as of the end of May 2009, APS also generates more jobs than most other Arizona corporations, and is one of the relatively few S&P 500 companies with headquarters here. Together with its employees, APS annually contributes more than $6 million and devotes more than 170,000 hours of volunteer time to literally hundreds of Arizona charitable, cultural, and educational organizations. Last year, the Company purchased from roughly 6,000 suppliers, 170 of which were certified minority- and women-owned businesses. Due to the extensive construction of electric infrastructure necessary to maintain the Company's existing system and meet future demand, APS is also essentially one of Arizona's largest construction companies. In 2008 alone, APS invested approximately $850 million into Arizona's economy as part of its ongoing construction program. This year, that number is projected to reach approximately $880 million, and will likely exceed $20 **billion** through 2025.

Perhaps most fundamentally, APS's product, electricity, is nothing short of vital to economic growth and a functional economy. Customers rely on APS to provide efficient, reliable electric service so that they can live, work, and prosper in their businesses. In sum, APS has a strong presence in the State and is a key contributor to the State's economy. As such, it is ideally positioned to help shape the economic success and sustainability of Arizona.

**Q. HAS THE CHANGE IN THE NATION'S ECONOMY AFFECTED THE COMPANY'S COMMITMENT TO CREATING A SUSTAINABLE ENERGY FUTURE?**

A. The degradation in the nation's – indeed, the world's – economy has had devastating impacts on the Company's financial condition. In fact, the downturn in the nation's economy and financial markets has caused revenue erosion and cost increases that have made APS's financial problem significantly worse today than it was when the Company first filed this rate case in June of last year. *See* Attachment JRH-1-S. But the current recession, and its impact on the Company's financial health, has not caused APS to deviate from its commitment to Arizona's energy future. To the contrary, APS believes that this is **precisely** the right time to focus on that vision.

The world of energy is changing: economically, politically, and environmentally. Notwithstanding the current economic slowdown, recent projections show that between now and 2025, APS's customer base will grow by almost 600,000 (rendering a total customer count of close to **1.7 million**). And despite an increasing focus on energy efficiency, the Company's electric sales will grow by over 16 million megawatt-hours ("MWh") – 55% over today's levels – during the same period. In order to continue serving our existing customers and meet this projected demand, APS will have to spend over $15 billion on improvements and additions to its existing infrastructure and billions more for additional generation. Other uncertainties, including the costs associated with potential climate change legislation, compound the challenge of meeting this demand in the most economically and environmentally sustainable manner.

While navigating these uncertainties presents significant challenges, the process of doing so is also filled with opportunities for APS and the Commission to work together to positively shape Arizona's energy future. By developing policies with a deliberate and continual understanding of how they affect the environment, customers, and the Company collectively, APS will be better positioned to manage the risks and take advantage of the emerging technologies and other innovative energy developments that surely lie ahead.

## IV. SETTLEMENT AGREEMENT

**Q. TO WHAT EXTENT DOES THE SETTLEMENT AGREEMENT ALLOW APS TO HELP IMPLEMENT A SUSTAINABLE ENERGY FUTURE?**

A. APS believes that the Settlement Agreement is a constructive resolution of the case before it and provides important stepping stones toward a regulatory process that will allow the Company and the Commission to create a sustainable future for this State. The Agreement itself represents a salient achievement by the Signatories, each of which worked hard together in a cooperative spirit to begin to resolve the challenges confronting both the Company and other key stakeholders. An important qualitative consideration rating agencies use in establishing credit ratings is the regulatory environment in which the utility operates. The very fact that the Signatories reached a productive agreement in this case displays what the markets view as continued improvement in Arizona's regulatory environment, thus increasing confidence that Pinnacle West and APS are companies worthy of investment.

I could not have put it better than preeminent equity analyst Dan Eggers, who, in reaction to the announcement of the Agreement, upgraded Pinnacle West's rating to "Outperform" from "Neutral" with the following justification: "**We see the PNW story at the cross roads of evolving into an investable story as evidenced by the constructive rate case settlement and recent actions, including forward looking transmission rates, interim rate increase and line connection adder**." *See* Credit Suisse Upgrade Rating, Pinnacle West Capital Corp., May 26, 2009.

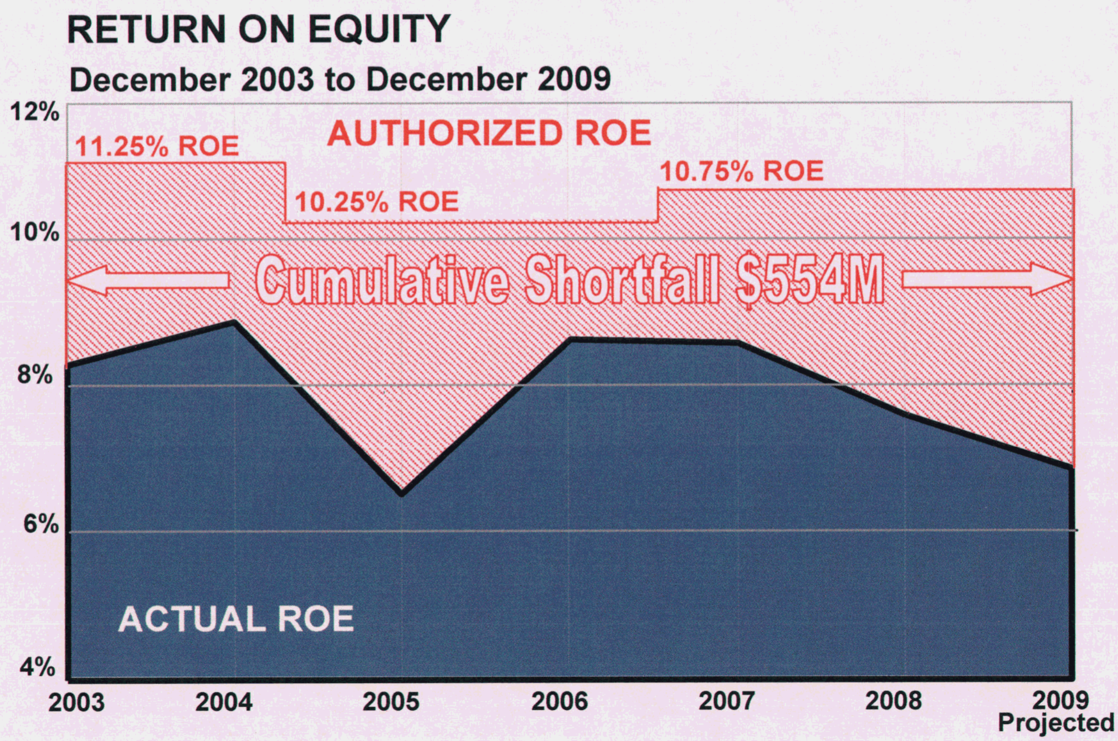
APS believes that it truly is at the "cross roads" of being an "investable" company and that the Settlement Agreement is an important milestone in that direction. In fact, APS firmly believes that the Agreement presents a key opportunity and framework for the Company, the Commission, and other interested parties to explore options that will strengthen the Company's financial condition for the long-term, thus allowing APS to be a critical contributor in creating a sustainable energy future for Arizona.

**Q. PLEASE ELABORATE ON THE OPPORTUNITY YOU BELIEVE THAT THIS AGREEMENT PROVIDES.**

A. The key opportunity presented by this Agreement is that it provides stakeholders with a framework that can address for the long-term the root of the financial difficulties facing the Company: rates that have not kept pace with the Company's increasing capital expenditures and operating costs. I am firmly convinced that the single largest challenge facing APS is that presented by the use of a historic test year for rate-making in today's cost intensive environment. The historic test year, combined with the ever-changing economic conditions in which the Company operates, has traditionally resulted in rates that are below the cost-levels that APS has faced at that time those rates became effective.

For example, because of the historic test year approach used in APS's last rate case, the Company's current revenues (the prices charged for the electric service that APS provides today) are based on the costs APS incurred in 2005 (the test year used in that case) – **almost half a decade ago**. In other words, even though APS's current costs are, like most people's, much higher today than they were in 2005 for a variety of reasons, the Company is required to pay those higher costs with a revenue stream that is five years outdated. In fact, the Company's current permanent rates do not include $2.5 billion worth of capital expenditure additions.

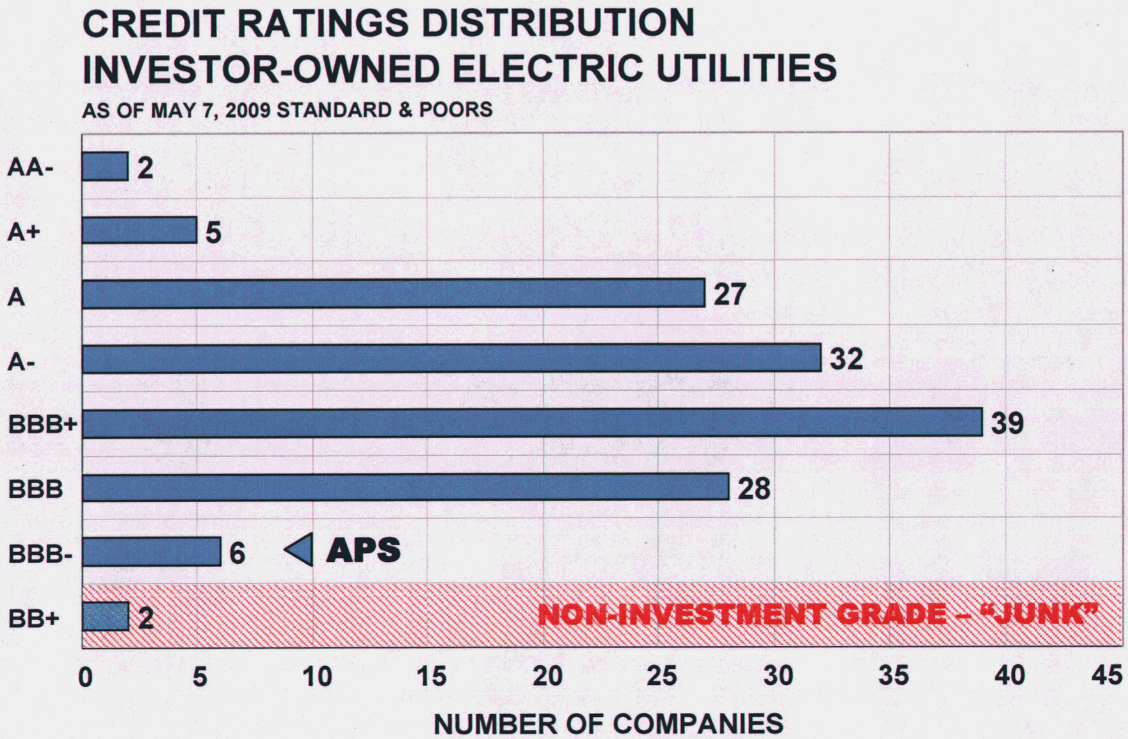
Insufficient to cover the Company's current cost of service on the date they became effective, such rates could not redress the earnings shortfall APS had historically experienced for the same reason – a shortfall illustrated by the following:




Graph JRH-1

Unless this issue is resolved, this shortfall will only increase and APS will remain in a vulnerable financial position. As a result, the Company will have difficulty raising the capital necessary to serve customers, and will continuously be exposed to potential credit downgrades, thus ultimately impairing both the level and cost of electric service for customers. As one regulatory financial expert succinctly stated, "[m]ore frequent rate filings, deterioration of financial conditions, downgrading of bonds and difficulty in attracting capital are the inevitable consequences of reliance on antiquated historical data." *See* Roger A. Morin, Regulatory Finance, at 4 (1994).

These consequences are a real concern for APS. In fact, as the following demonstrates, APS is still among the lowest rated investor-owned electric utilities in the country, with credit ratings that are as low as they can be without being rated junk bonds.




Graph JRH-2

This reality hurts not just APS but its customers and all of Arizona, for it jeopardizes APS's ability to secure capital at reasonable costs, thus impacting both the cost and level of investment in Arizona that APS is able to provide. Unless APS has the financial wherewithal to both meet its basic needs and make the requisite investment, the Company simply will be unable to successfully implement the programs and policies intended to benefit the State's energy future.

It comes down to this: what level of service and reliability does the State of Arizona want and what is the price required to support that level of service and reliability? I believe that the Settlement Agreement sets forth a framework for resolving that question both now and in the future, thus providing a key opportunity for APS to help promote a sustainable energy future for the State.

**Q. SPECIFICALLY, HOW DOES THE AGREEMENT PROVIDE THE OPPORTUNITY TO RESOLVE THE CHALLENGE YOU PREVIOUSLY DESCRIBED?**

A. The Settlement Agreement provides several building blocks on which stakeholders can work in collaboration to strengthen APS, thus providing significant benefits for all. For example, recognizing the significant capital expenditures that APS has already made beyond the 2007 Test Year and will continue to make before rates in this matter are proposed to take effect in January 2010, the Signatories included in rate base plant additions that the Company has made through June 2009 – 18 months after the Test Year. Although the resulting rates still will not fully compensate the Company for all capital expenditures made up to the proposed rate-effective date (January 2010), this adjustment is nonetheless a notable move in the right direction.

In addition, the Settlement Agreement provides for several procedural refinements intended to expedite future APS rate cases, thus further reducing the revenue-eroding impact of regulatory lag. For example, it requires the Parties to use good faith efforts to process APS rate cases within 12 months of a sufficiency finding, and identifies certain process improvements that will better enable them to do so. The Agreement also establishes a three year rate case cycle for APS, which can and should be used as the starting point for more regular, stable filings over time (to the benefit of all stakeholders in these proceedings), once APS is financially sound. It improves APS's Demand Side Management adjustment mechanism, allowing for more concurrent recovery of costs related to the Company's energy efficiency programming. It also requires the Company to undergo a benchmarking analysis and report on several operational areas, a provision that the Company views as a tremendous opportunity to put to rest any concerns about the adequacy of APS's operational strength and cost management.

Finally, the Agreement as proposed likely provides for sufficient revenue and related financial relief to maintain the Company's existing financial condition until the time APS is permitted to file another rate case.

**Q. DESCRIBE THE IMPACT OF THE SETTLEMENT AGREEMENT ON THE COMPANY'S FINANCIAL CONDITION.**

A. While many of the Agreement's provisions can and should be used as building blocks toward designing a regulatory structure that will help the Company improve financially over the long term, the Agreement in and of itself does not get us there. The financial impacts on the Company of the proposed Settlement Agreement are detailed in Attachment JRH-2-S.

As that Exhibit shows, even under the provisions of the Agreement as proposed, APS projects that it will **actually** earn an ACC-Jurisdictional ROE of just 9.4% in 2010, 8.4% in 2011, and 8.1% in 2012. These earnings are significantly below not only the Settlement's proposed ROE of 11% and the ROE recommended by any other party to these proceedings, but are also below the actual earned ROE of the industry peers against whom APS competes for invested capital (a point I will later discuss in detail).

In short, the ROE that actually results from the revenue requirement to which the Company agreed is significantly less than what it needs to earn to invest in this State's energy future. There is simply no room for further degradation in the Company's financial metrics – a fact that highlights how critical it is both that (1) the rate schedule set by the Signatories in the Agreement is not extended, thus permitting APS to seek a rate increase that would be effective in 2012; and (2) APS receives, in some form or another, the full amount of the revenue requirement and other financial measures proposed by the Signatories (including the revenue treatment of Schedule 3, deferral of pension and OPEB costs, and the depreciation rate update relating to the Palo Verde license extension). In other words, to the extent the Commission decides to change any of the Agreement's provisions, such change must be revenue- and financially-neutral for the outcome to remain a viable one for APS.

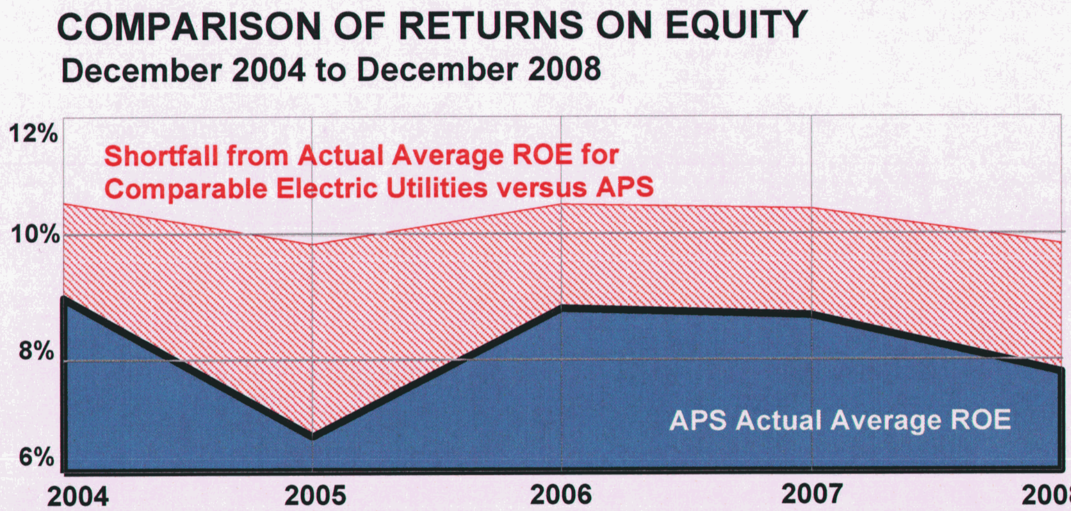
**Q. WHY IS THE COMPANY'S ACTUAL RETURN ON EQUITY IMPORTANT?**

A. In every APS rate case, the Commission sets the Company's recoverable cost of capital – both for debt and equity – based on what it believes investors in the Company should reasonably expect to receive, not hypothetically, but in reality when the new rates are in effect. In Decision No. 69663, the Commission authorized APS to receive a 10.75% ROE. In other words, the Commission determined that it was reasonable that APS's rates should generate enough revenue to both cover the Company's operating expenses and give APS and its shareholders a 10.75% return on their investment (the Company's "earnings"). In the proposed Settlement Agreement, given the increased risk investors assume by investing in the Company's equity in the current market, the Signatories have agreed that an 11% ROE is a reasonable one. This cost of capital was originally proposed in and is amply supported by the Testimony of Staff Witness David Parcell.

But investors looking to purchase equity in the Company do not look primarily at the Company's **authorized** ROE. Rather, before deciding whether to put their money into APS as opposed to any of the other companies against which APS competes for capital investment – including other investor owned utilities – they look at the **actual** return that they are likely to receive: APS's **earned** ROE. Unless APS has the actual and real opportunity to earn its authorized rate of return (which I understand is a right grounded in the Constitution), the ROE set by the Commission is little more than a number to potential investors.

By that standard, APS's financial performance falls well below the mark. Indeed, the Company's current returns provide little incentive for investors to put their money into APS compared to the portfolio of less risky opportunities available elsewhere in the electric industry. For investors, investment decisions are not personal, but are rationally based on what amounts to a clinical analysis of which investments are likely to bring the highest returns. As the following illustration shows, APS does not compare favorably next to other comparable[1] companies in the industry whose earned returns are significantly higher.

[1] The companies used in this comparison are those that, like APS, are electric only, publicly-owned operating companies that have more than 100,000 customers and own at least 20% of their base load generation. These are the companies against which APS competes for equity investment.




Graph JRH-3

As the foregoing demonstrates, APS fights an uphill battle trying to attract equity investment with such comparably low returns.

Neither will existing equity investors in APS willingly allow their investment to systematically underperform. By this, I mean that current investors will not accept less than the cost of capital just because APS needs that capital or because the economy is bad. This is particularly true when the Company's actual earned returns are below the rate at which APS just issued **debt** (at 8.75 percent). So if APS's cost of equity capital is 11 percent as proposed in the Settlement Agreement, or 10.75 percent as found in Decision No. 69663, any earned return significantly less than that does not meet the market's requirement for attracting new equity on reasonable terms or provide any incentive for current equity investors to retain their investment in APS any longer than is necessary to liquidate it.

Without capital investors, APS will have lost an essential source of funding for its significant capital projects – projects needed not just to meet future demand, but to maintain APS's existing electric system and provide the foundation for a more sustainable future for this State. Even if APS were to be able to issue equity with such low returns, such issuances would certainly be made under onerous terms (requiring striking discounts to the Pinnacle West's stock price per share), thus substantially driving up the cost of APS's capital program – an end that ultimately translates into higher electric rates for customers.

Maintaining the status quo is thus, in the long run, a lose-lose proposition for both the Company and the many stakeholders to this proceeding. Conversely, companies with higher levels of earnings are able to attract both debt and equity investment on better terms, thus **lowering** the ultimate cost to customers. Higher revenue streams from rates that cover the Company's cost of service also allow APS to reduce to a degree otherwise required debt and equity issuances, thus keeping the cost of capital borne by customers to the necessary minimum.

In the end, improving the Company's earnings – even if difficult in the short term – will keep the price of electric service down and ensure that APS has the capital it needs to continue to invest in the energy future of this State. This is the win-win scenario toward which I believe all stakeholders should collectively strive.

**Q. WHY SHOULD CHRONIC APS UNDEREARNING BE A CONCERN TO THE COMMISSION AND APS CUSTOMERS WHEN APS IS STILL MAKING A PROFIT?**

A. All stakeholders in these proceedings should be concerned about resolving the Company's chronic underearning because, without substantial improvements to APS's financial health (particularly in today's troubled economy), the Company will be unable to provide reliable electric rates at reasonable prices while working towards a sustainable energy future for Arizona.

To continue its long history of service reliability, APS simply must recover on a regular basis its cost of providing service. More than a basic legal and regulatory requirement, it is also a practical economic necessity. Examples exist throughout the industry of utilities forced to cut back on services in one way or another to compensate for a revenue stream that did not allow a sufficient return to attract the capital that the utility needed to continue to serve customers in the manner to which they were accustomed. Neither APS nor, I believe, its customers, this Commission, or anyone else wants the Company to be in a position where it is forced to cut back on service so that it can cover its basic costs, including the cost of capital.

In addition, in setting rates below the Company's costs, the Commission sends the wrong price signals to customers who will not know – because they do not pay – the real cost of electricity. In an era of energy conservation, it makes little sense to set the price of this essential commodity **too low**. To reduce vehicle emissions one would not **decrease** the price of gas; doing so would send the entirely wrong message. To encourage energy efficiency, among other things, customers should know and be required to pay the real cost of electricity, not a subsidized one.

**Q. IN THE PAST, APS HAS EXTENSIVELY DISCUSSED THE FFO/DEBT RATIO. SHOULD THAT METRIC ALWAYS BE THE FOCAL POINT IN ASSESSING THE COMPANY'S FINANCIAL CONDITION?**

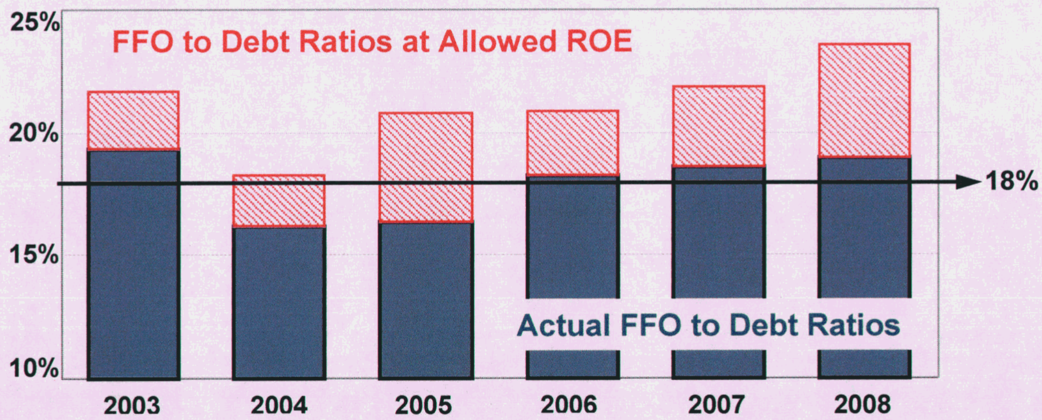
A. Although FFO/Debt was the proper focus in the Company's past emergency rate proceedings, since the alternative was non-investment grade, that metric should not be the single focal point for assessing APS's financial health. As the Commission knows, APS is an investor-owned utility to which three primary credit rating agencies assign a credit rating. Capital markets use that rating to determine whether or not the Company is worth investing in at all, and, if so, at what cost. Simply put, the worse the Company's credit rating, the higher its financing costs (costs that are ultimately borne by customers). The consequences of having a low credit rating are particularly difficult in the current, still volatile credit markets, where access to the market is often blocked to subpar performers and financing costs are at a premium.

In each of the Company's past emergency rate cases, APS believed that it was on the brink of downgrade – in large part because its FFO/Debt ratio had fallen or was projected shortly to fall below the 18% FFO/Debt threshold level set by S&P for the Company's current credit rating (BBB-, the lowest rating possible before falling into "junk" status). While the FFO/Debt metric is a crucial consideration in emergency cases when APS believes that a downgrade is imminent, it should not be the long-term focal point in assessing the Company's financial health overall. Revenue increases based solely on keeping FFO/Debt at or above that 18% threshold will **never** improve the Company's financial condition because they ignore the root of the Company's financial problem: insufficient equity returns.

If APS and the Commission focused on fashioning rate relief that gave APS the real opportunity to earn its ROE (rather than maintaining minimally acceptable FFO/Debt levels), **all** of the Company's credit metrics would improve because APS would have sufficient revenue to meet its basic expenses and offset debt. As the following illustration shows, had APS earned its allowed ROE since 2003, its FFO/Debt ratio would never have been an issue.

## IMPACT OF UNDEREARNING ON FFO TO DEBT RATIOS

**December 2003 to December 2008**




Graph JRH-4

The foregoing demonstrates that had rates been at the level required for the Company to earn its allowed returns since just 2003, FFO/Debt would not be teetering continually on the edge of junk status, and the Company would be less reliant on tumultuous capital markets. As a result, the Company's need for constant rate filings to protect against a credit downgrade would have been alleviated. With greater revenues, investors would be much more inclined to put money into the Company, APS's credit rating would almost certainly elevate (thus **lowering** APS's financing costs and the rates ultimately charged to customers), and APS would have the financial means needed to invest in the sustainable energy future envisioned for Arizona.

**Q. IF APS BELIEVES THAT THE SETTLEMENT RESULTS IN SUCH MARGINAL RETURNS ON EQUITY, WHY DID APS AGREE TO IT?**

A. APS agreed to this Settlement for several reasons. First, it appreciated the Signatories' clear and cooperative attempt to fashion an Agreement that addresses the significant challenges that APS and all stakeholders face today, even if only for a few years. Second, the Company recognized that, because economic and financial conditions had deteriorated from when it first filed this rate case in June of 2008, its original asking was inadequate compared to its current revenue needs and – even if granted in full – would not have restored APS to financial health. Third, and most significantly, APS firmly believes that the opportunities set forth in this Agreement for a long-term solution outweigh the shorter term financial struggles the Company will face in the next few years.

**Q. ONE MIGHT ASK WHETHER INADEQUATE COST MANAGEMENT IS THE SOURCE OF THE COMPANY'S FINANCIAL PROBLEMS. HOW DO YOU RESPOND?**

A. There is no doubt in my mind that the reason for APS's poor earnings is insufficient revenues as opposed to excessive costs. Since joining APS and Pinnacle West in July 2008, I have witnessed first-hand the Company's commitment to cutting costs, deferring non-critical expenditures, and otherwise managing its finances in a way that helps relieve the short-term financial pressures without jeopardizing service reliability. From an operational perspective, the Company demonstrates top-quartile performance in fossil generation, reliability, and customer service. In terms of managing costs, the Company has, among other things and after extensive operational analysis, eliminated jobs, imposed a hiring freeze, increased insurance retentions, cancelled merit increases for Officers and Senior Management, reduced merit increases for other non-union workers, and reduced working capital requirements. These measures are thoroughly outlined in a letter from APS President Don Robinson to the Commission, filed on March 18, 2009, attached hereto in Attachment JRH-3-S. And in this Settlement, APS has committed to further annual expense reductions for the term of the Agreement.

But cost-cutting alone cannot significantly improve the Company's financial condition. APS simply cannot cut enough expenses to earn its authorized rate of return without significantly sacrificing reliability and quality of service. Despite APS's cost-management efforts and the additional revenue resulting from the interim rate proceeding, APS **still** has an annual revenue requirement deficiency of $260 million for 2010 – $80 million more than will be recovered under the terms of this Agreement. To address this deficiency solely on the cost side rather than the revenue side would mean eliminating projects or services that are nothing short of vital to APS's basic service obligations, such as repairing and replacing older or damaged distribution facilities and serving our growing customer base. APS certainly would not willingly resort to sacrificing reliability in order to improve its financial condition, and highly doubts that its customers or the Commission would want it to either.

Regardless of the outcome of this proceeding, I guarantee that the Company will continue to explore ways to improve its financial performance internally through sound business judgment and management choices at all levels of the Company's operations. However, as a relative newcomer to the Company with substantial experience in the utility industry, I would like to emphasize two key points: (1) it is my opinion that this is a very well-managed company; and (2) cost cutting alone cannot significantly improve the key financial metrics. That will only happen by addressing the chronic underearning suffered by the Company.

**Q. HOW DO YOU RESPOND TO THE SUGGESTION THAT THE COMPANY'S CONTINUAL EARNINGS SHORTFALLS SHOULD HAVE BEEN ALLEVIATED BY THE IMPLEMENTATION OF THE POWER SUPPLY ADJUSTOR, TRANSMISSION COST ADJUSTOR, ETC.?**

A. While the Company certainly appreciates the mechanisms the Commission has put in place since 2003 to deal with unrecovered costs and bolster the Company's cash flow, these mechanisms have not materially improved and cannot improve the Company's earnings because they merely facilitate the recovery of previously incurred costs. Significantly, of the Company's total revenue increases since 2003, the amount that has gone to cover the striking growth in rate base investment and non-fuel O&M costs that APS has experienced over the past six years would constitute just over a four percent rate increase – and more than half of that resulted from the interim increase authorized in this docket, which is included in the overall increase proposed by this Agreement. The overwhelming majority of the Company's recent rate increases, recovered through such mechanisms as the PSA, recovers fuel and other expenses that are a mere pass-through of costs for the Company, which do not improve APS earnings. The key piece of the puzzle is to address the earnings shortfall resulting from historically large capital expenditures coupled with regulatory lag so that the Company can begin to earn its cost of capital, a critical element for the Company to regain its financial health and support a sustainable energy future for Arizona.

**Q. SHOULD APS ACCEPT LOWER RETURNS GIVEN HOW THE GENERAL DOWNTURN IN THE ECONOMY HAS AFFECTED INDIVIDUALS AND OTHER COMPANIES?**

A. APS certainly recognizes the effect that the current economic downturn is having on its customers and other individuals and companies throughout Arizona and the United States. The Signatories, in fact, attempted to minimize the impact of the proposed rate increase by including a provision in the Agreement that accelerates the refund that may be owed customers under the PSA, which could result in a net increase to base rates of less than 5%. And while an increase in the price of electricity may be more difficult for customers to absorb in hard economic times, the Commission should be aware that APS rates have increased substantially less than the rate of inflation in this decade, and that, even under the provisions of the Agreement, electricity is a smaller percentage of personal income than it was ten years or more ago.

Moreover, unlike other businesses facing a financial crisis, APS has an obligation to continue to provide electric service to all present and future customers, even in hard economic times. As a regulated utility under a "cost of service" regulation model, APS is not permitted to increase its profit margins by increasing electric rates in good times. This ensures that electricity – a basic need of the modern world – remains as affordable as possible, based only on the cost to APS of providing service. On the flip side, recognizing that cost of capital is a basic cost of providing electric service and that adequate earnings are necessary to attract the capital needed to continue serving the public reliably and affordably, the cost-of-service model is also designed to give the Company the opportunity to earn its authorized profit margin even when times are tough and the economy has slowed. Doing so will ensure continued investment in Arizona's electric utilities, the continued provision of reliable electric service at reasonable costs, and the creation of a sustainable energy future.

## V. CONCLUSION

**Q. DO YOU HAVE ANY CONCLUDING REMARKS?**

A. Yes. APS strives towards a future of working with the Commission to create a sustainable energy future for Arizona, but currently lacks the financial wherewithal necessary to do so. Utilities across the country, faced with many of the same challenges confronting APS, share the Company's need for base rate increases. Many states have already adopted mechanisms to reduce regulatory lag and that result in rates that recover a utility's cost of service. Other states are now in the process of adopting and implementing new regulatory mechanisms with the same goal. For APS, the Settlement Agreement is similarly a critical step towards reducing the impact of regulatory lag and providing rates that cover the Company's actual cost of service at the time they become effective. Only with such progress will the Company's financial condition improve, thus allowing the Commission and APS to focus on putting in place the important policies that will help shape this State's energy future. With this in mind, APS urges that the Commission approve the Settlement Agreement.

**Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

A. Yes.

## Major Items Causing the Deterioration of Projected 2010 ACC Financial Results from June 2008 Rate Request to the Settlement Proposal

$ in Millions

| Line | | Earnings After Income Taxes | Average Common Equity | ACC ROE |
|---|---|---|---|---|
| 1 | Projected 2010 ACC results under the Company's June 2008 rate request | $ 362 | $ 3,339 | 10.8% |
| 2 | Reduced non-fuel base rate increase $68m from $264.3m to $196.3m (10.0% to 7.4%) through settlement negotiations (measured on 2007 test year) | (41) | | |
| 3 | Reduced revenues after related fuel and purchased power savings of $55m from lower projected sales growth due to the economic downturn and energy efficiency programs | (33) | | |
| 4 | Higher pension and opeb costs of $14m due to financial market conditions | (8) | | |
| 5 | Higher interest costs of $10m on February 2009 $500m long-term debt issuance due to financial market conditions | (6) | | |
| 6 | Low income bill assistance funding of $5m in 2010 agreed to through settlement negotiations | (3) | | |
| 7 | Assumed cost reductions of $28m ACC share | 17 | | |
| 8 | Other changes | 3 | | |
| 9 | Total change in projected 2010 ACC earnings | (71) | | |
| 10 | Projected 2010 ACC results under the proposed settlement agreement | $ 291 | $ 3,087 | 9.4% |

# ARIZONA PUBLIC SERVICE COMPANY
## PROJECTED INCOME STATEMENTS
## WITH PROPOSED SETTLEMENT RATE INCREASE
(Dollars in Thousands)

| Line No. | Description | Projected Year - Total Company Year Ending 12/31/2010 | Year Ending 12/31/2011 | Year Ending 12/31/2012 | Projected Year - ACC Jurisdiction Year Ending 12/31/2010 | Year Ending 12/31/2011 | Year Ending 12/31/2012 |
|---|---|---|---|---|---|---|---|
| 1. | Electric Operating Revenues | $3,404,430 | $3,445,936 | $3,586,487 | $3,301,488 | $3,344,423 | $3,481,929 |
| 2. | Fuel and Purchased Power | 1,247,359 | 1,241,234 | 1,313,613 | 1,347,016 | 1,367,368 | 1,454,166 |
| 3. | Operating Revenues Less Fuel Expenses | 2,157,071 | 2,204,702 | 2,272,874 | 1,954,472 | 1,977,055 | 2,027,763 |
| | Other Operating Expenses: | | | | | | |
| 4. | Oper and Maint excluding fuel expense* | 888,854 | 930,026 | 956,765 | 840,096 | 878,705 | 903,335 |
| 5. | Depreciation and Amortization | 417,205 | 438,429 | 431,862 | 369,351 | 387,114 | 378,085 |
| 6. | Income Taxes | 196,592 | 187,462 | 192,989 | 175,890 | 160,782 | 163,876 |
| 7. | Other Taxes | 139,810 | 140,902 | 148,853 | 120,877 | 121,830 | 128,705 |
| 8. | Operating Income | 514,610 | 507,883 | 542,405 | 448,258 | 428,624 | 453,762 |
| | Operating Income (Deductions): | | | | | | |
| 9. | Income Taxes | 6,010 | 5,039 | 6,159 | 1,908 | 253 | 116 |
| 10. | Allowance for equity funds used during construction | 27,819 | 28,407 | 32,757 | 18,900 | 20,100 | 21,255 |
| 11. | Other Income | 1,117 | 769 | 1,215 | (104) | (682) | (313) |
| 12. | Other Expenses | (17,385) | (14,476) | (18,083) | (5,000) | - | - |
| 13. | Total | 17,561 | 19,739 | 22,048 | 15,704 | 19,671 | 21,058 |
| 14. | Income Before Interest Deductions | 532,171 | 527,622 | 564,453 | 463,962 | 448,295 | 474,820 |
| | Interest Deductions: | | | | | | |
| 15. | Interest on long-term debt | 207,244 | 210,426 | 240,381 | 169,747 | 170,543 | 193,231 |
| 16. | Interest on short-term borrowings | 11,337 | 15,609 | 14,777 | 9,286 | 12,651 | 11,879 |
| 17. | Debt discount, premium and expense | 4,991 | 4,903 | 4,100 | 4,991 | 4,903 | 4,100 |
| 18. | Allowance for borrowed funds used during construction | (16,720) | (17,093) | (19,700) | (11,392) | (12,086) | (12,796) |
| 19. | Total | 206,852 | 213,845 | 239,558 | 172,632 | 176,011 | 196,414 |
| 20. | Net Income | $ 325,319 | $ 313,777 | $ 324,895 | $ 291,330 | $ 272,284 | $ 278,406 |
| 21. | % Return on Average Common Equity | 8.6% | 7.8% | 7.6% | 9.4% | 8.4% | 8.1% |
| 22. | Average Common Equity | 3,773,157 | 4,006,397 | 4,249,416 | 3,087,229 | 3,248,686 | 3,417,963 |

Notes:
* Includes expenses related to Renewable Energy Standard and Demand Side Management programs

APS

A subsidiary of Pinnacle West Capital Corporation

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Director Utilities

Docket Control
ARIZONA CORPORATION COMMISSION
1200 West Washington
Phoenix, Arizona 85007-2996

**Re:** ***Compliance Filing of Arizona Public Service Company Regarding Cost Management Efforts, Docket No. E-01345A-08-0172 (Interim Rate Proceeding)***

Dear Sir or Madam:

In Decision No. 70667 (December 24, 2008), the Commission directed Arizona Public Service Company ("APS" or "Company") to examine its operations and expenses and employ "easily identifiable short term measures" to improve its financial condition. That decision indicated that APS should target additional cost reductions to operations and expenses of at least $20 million. The specific reductions to be included in this effort were left to APS's discretion, but the decision directed APS to consider such items as (1) reducing lobbying expenses, (2) reducing advertising expenses, (3) paring back management compensation for 2009, (4) imposing a temporary hiring freeze for all non-essential personnel, (5) examining payroll overhead, and (6) implementing a freeze on any increases in its dividend in 2009.

APS has identified and is in the process of implementing a minimum of $25.9 million of specific cost reductions to operations and other costs for 2009, which are described below and summarized on the attached Table 1. These cost reductions are in addition to the substantial cost management savings that have previously been discussed with the Commission. (*See* October 14, 2008 and November 26, 2008 letters, both of which are attached.) Further, APS is committing to several of the specific actions identified in Decision No. 70667, including a dividend freeze and a hiring freeze for non-essential personnel for the remainder of 2009.

In identifying and pursuing these additional cost reductions, APS has sought to carefully balance the benefit of attaining short-term improvements in the financial condition of the Company with the risk of resultant long-term adverse consequences to our customers and the Company—certainly a challenge that many businesses are faced with in today's economy. The actions APS is taking with respect to each such specific cost reduction area identified in the decision is discussed below, followed by a discussion of other cost management actions APS is implementing, concluding with an update on the overall cost management efforts of the Company.

## I. Specific Areas Referenced in Decision No. 70667

***Lobbying Expenses.*** APS's 2009 lobbying budget, for both state and federal lobbying, has been reduced by $500,000. This represents nearly a 20% reduction to the total budget, even though current state and federal legislative activity is higher, more complex and more important than at any time in recent memory. Much of this savings will be achieved from the cancellation or non-renewal of outside services agreements.

***Advertising Expenses.*** APS currently receives specific funding for customer outreach and program marketing relating to RES and DSM activities from surcharges, which will remain at current Commission-approved levels. However, APS has reduced its remaining non-funded advertising budget by approximately 30% or $1,000,000. This non-funded advertising budget had supplemented RES and DSM advertising programs, largely in the area of developing and producing new advertisements and messages focused on renewable energy, energy efficiency and safety. Nevertheless, APS believed it appropriate to make these reductions. The remaining APS advertising budget will continue to emphasize renewable energy, energy efficiency, customer programs and safety.

***Management and Other Compensation.*** APS had incorporated a higher base salary amount in its 2009 budget. This was not a cost of living adjustment, but instead reflected APS's long-standing practice of granting annual merit increases based on both individual performance and labor market trends. The Company determined, however, to freeze all officer and senior managers salaries at levels established in late 2007, and to freeze all other management salaries at 2008 levels.[1] In addition, merit increases for non-union[2] frontline employees were significantly reduced or eliminated. The APS share of total savings resulting from this action was $7.5 million. APS also has frozen contractor wage increases for 2009. APS estimates its share of those savings to be an additional $1.8 million.

[1] An employee who receives a promotion, however, could move into a higher grade.

[2] APS's current collective bargaining agreements contractually specify how annual union base pay increases are to be implemented and could not be modified.

***Temporary Hiring Freeze.*** APS requires CEO approval to fill any new position or any vacant position with an outside hire, and such approval will be provided for only the most critical positions.

***Payroll Overhead.*** The Company has modified its medical plan program to reduce the medical costs absorbed by APS, primarily by increasing co-pays and limiting the scope of certain benefits. Total APS savings from this change will be approximately $1.2 million.

***Dividend Freeze.*** APS will not increase its dividend in 2009.

**II. Other Cost Savings Identified by APS**

In addition to the areas described above, APS has identified cost savings in other areas:

***Fossil Generation O&M.*** APS will reduce fossil plant O&M by reducing or deferring work on various maintenance items in 2009, including deferring certain maintenance work at the Four Corners, West Phoenix, Cholla, and Redhawk power plants. APS share of these savings will be approximately $4.1 million.

***Other O&M Reductions.*** APS will also reduce or postpone various activities in legal, customer service, information services, delivery, finance and facilities. For example, APS will further consolidate and streamline its call center functions, reduce the level of internal mail service at various Company locations, and reduce insurance limits. APS savings from these reductions will be approximately $4.0 million.

***Supply Chain Cost Reductions.*** APS is implementing a new supply chain management sourcing effort that will reduce the price paid for wood, steel and concrete poles and towers. Estimated annual savings are approximately $1.5 million.

***Freight and Delivery Cost Reductions.*** APS is implementing a new company-wide initiative to reduce freight costs and optimizing material delivery costs that will result in an annual savings of approximately $1.3 million.

***Renegotiated Call Center Contract.*** APS has renegotiated a contract for APS Call Center contract labor resulting in annual savings of approximately $500,000.

***Lowering Technology Services Support.*** Technology services support related to responsiveness and availability for APS departments will be reduced. APS savings will be approximately $1 million.

***Reduction of Short Term Interest Expense.*** APS will reduce working capital in an amount that would result in an annual reduction of short term interest expense by at least $1.5 million.

APS believes that the estimates of cost savings identified above are conservative. These cost savings do not reflect any estimate of potential vacancy savings in 2009 from the more restrictive hiring freeze. Neither does it include additional interest, depreciation, and property tax savings from reduced capital expenditures. In that regard, and in addition to those cost reductions previous announced, APS recently eliminated another $72 million from its 2009-2011 capital budget.

## III. APS's Overall Cost Management Efforts

APS has approached these additional cost reductions similarly to the cost reductions announced last year—with a critical and often difficult balancing of short-term and long-term impacts to our customers, employees and operations. The challenges facing both our industry and our state are significant, further complicating this balancing process. APS remains committed to maintaining reliability and customer service, while efficiently and proactively planning for the future in these most uncertain of times. For example, the Resource Plan Report submitted to the Commission earlier this year is a key element of the Company's long-term planning.

High-quality customer service, reliability, prudent long-term planning, resource diversity, operational excellence—all the things that go into sustainability—require APS to be financially strong so that it can attract and retain the resources, both capital and human, necessary to fulfill its obligations to the public and its over one million Arizona customers. As APS has indicated in its pending rate case, long-term improvement in the financial health of the Company cannot be achieved solely through more aggressive cost management, but must be complemented with prices that truly reflect APS's prudent and reasonable cost of providing service. At the same time, APS recognizes that it has the responsibility to actively and effectively manage those costs without compromising service and reliability and without sacrificing long-term efficiencies for short-term benefit.

## IV. Conclusion

The Company is committed to cost management in both good times and bad. But the current economic circumstances for APS and its customers make those efforts doubly important. APS does not intend to stop its cost containment efforts with just the actions identified above but will rather continue to build on them throughout this year and into future years. In all such efforts, the focus will remain on APS's core values of safety, reliability, customer service, and value for customers.

Sincerely,

Donald G. Robinson

cc: Chairman Mayes
Commissioner Pierce
Commissioner Newman
Commissioner Kennedy
Commissioner Stump
Michael Kearns
Ernest Johnson
Terri Ford
Barbara Keene
Janice Alward
Brian Bozzo
Parties of Record

**Table 1: Summary of Cost Reductions**

| Area | Action Being Taken | Cost Savings |
|---|---|---|
| Lobbying Expenses | Reducing expenditures, including reduced consulting arrangements | $500,000 |
| Advertising | Reducing expenditures primarily related to design and production | $1,000,000 |
| Management and Employee Compensation | Freezing base compensation for all management employees and many non-union frontline employees | $7,500,000 |
| Contractor Wage Freeze | Freezing wage or salary increases for contractors | $1,800,000 |
| Reduced Payroll Overhead | Modifying medical plan to require higher co-pays and limit certain benefits coverage | $1,200,000 |
| Fossil Plant | Deferring or reducing various maintenance items for 2009 | $4,100,000 |
| Legal, Customer Service, Information Services, Delivery, Finance and Facilities | Deferring or eliminating various activities and support functions in each of these areas, such as consolidating and streamlining call center functions, reducing internal mail service, and modifying insurance coverages | $4,000,000 |
| Supply Chain Management | Reducing cost of acquiring wood, steel, and concrete poles | $1,500,000 |
| Freight Delivery | Reducing and optimizing freight and delivery costs | $1,300,000 |
| Call Center | Reduce contract labor costs | $500,000 |
| Technology Services | Reduce level of technology support for various business units | $1,000,000 |
| Short-Term Interest | Reduce level of required working capital resulting in interest savings | $1,500,000 |
| ***Total*** | | ***$25,900,000*** |

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This 18th day of March 2009 to:

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PINNACLE WEST
CAPITAL CORPORATION
LAW DEPARTMENT

Thomas L. Mumaw
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October 14, 2008

Hon. Lyn Farmer
Chief Administrative Law Judge
Hearing Division
ARIZONA CORPORATION COMMISSION
1200 West Washington Street
Phoenix, Arizona 85007

Re: Docket No. E-01345A-08-0172 (APS Interim Rate Request)
APS Late-Filed Exhibit 23

Dear Judge Farmer:

As stated in my letter to you dated September 26, 2008, this is the second part of Arizona Public Service Company's ("APS" or "Company") response to the outstanding requests for certain information in the above proceeding. Per your instructions, this letter and its attachments have been designated as APS Exhibit 23.

Attachment 1 to this letter provides a more detailed breakdown of reduction in the anticipated capital expenditures ("CAPX") for the years 2009-2011. It does so by first beginning with the CAPX forecast presented in Exhibit DEB-3, which is an attachment to Donald E. Brandt's Direct Testimony in the pending general rate case, but with 2011 added using the same assumptions that had been used for the years 2009 and 2010 in Exhibit DEB-3.[1] The net changes to the CAPX forecast as of October 2008 are set forth separately. As you can see, anticipated CAPX reductions in distribution, transmission and general plant actually exceed $500 million[2] APS has provided the CAPX forecast changes in the same format and to the same level of granularity as in Exhibit DEB-3 for ease of

[1] The rate case testimony attachment had not addressed 2011 because it was 2010 that formed the basis for the Company's proposed attrition adjustment. However, to start everyone off on the same page with an "apples to apples" comparison; APS added what would have been the 2011 forecast using the same assumptions as for 2009 and 2010 in DEB-3.

[2] As the Commission is aware, Palo Verde is operating under a separate Performance Improvement Plan and is not included in the general Company efficiency/cost reduction program that will produce the reduction in future CAPX. Therefore, and although Palo Verde CAPX may change for reasons unrelated to the more general CAPX reduction program, it is held constant at DEB-3 levels for purposes of this analysis.

comparison. This means, for example, that while the major transmission projects that will be delayed are specifically identified to the extent they were in the prior CAPX forecast, smaller projects (and even larger projects that were not included in the earlier 2008 DEB-3 forecast) are shown collectively at line 22. Please also note that these represent preliminary estimates that may change materially, either up or down, depending on future events and more specifically, depending on the needs of our customers.

Although not specifically requested, APS believes there was some confusion during the recent hearing over the CAPX forecast submitted in August of 2007 and that subsequent CAPX forecast attached to Mr. Brandt's general rate case testimony. *See* Brandt Testimony at 602:7 – 603:10. A great deal, if not all, of the differences between the two forecasts is a result of the differing vintages of the forecasts. Although provided in August of 2007, what was then requested was a breakdown of the capital items identified back in late 2006 as Exhibit 27 in the Company's last general rate case. As can be seen on Attachment 2, the actual vintage of the forecast that resulted in both Exhibit 27 and the August 2007 filing was August of 2006 – some 21 or 22 months earlier than the forecast used for DEB-3 (rather than the six or seven months referenced at the time of the hearing) and well prior to the Company's announcement of $200 million CAPX reductions in late 2007 and early 2008 (which, of course, have recently been significantly expanded). Attachment 2 provides a reconciliation between the two vintages of CAPX forecast. APS would add that although the actual time between the two forecasts is considerably longer than what may have been thought during the recent interim rate hearing, even if there had been "only" a six month difference, it is still very possible that a CAPX forecast could materially change in such a relatively short period of time.

APS believes this letter has been responsive to the issues discussed above and would request admission of the letter and its attachments as APS Exhibit 23 in accordance with the procedure outlined by your honor on September 19.

Sincerely,

Thomas L. Mumaw

Thomas L. Mumaw

Attorney for Arizona Public Service Company

TLM/Attachments

Original and 13 copies of the foregoing filed
this 14th day of October 2008 with:

Docket Control
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and

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# Attachment 1

**Arizona Public Service Company**
**Cost Efficiency Program Impact on Construction Expenditures Projection 2009 - 2011**
**$Millions**



| line | | 2009 | 2010 | 2011 | 3 - yr Total |
|---|---|---|---|---|---|
| 1 | **2008 Rate Case Forecast per note below** | **1,085** | **993** | **964** | **3,042** |
| | **Changes as a result of the Cost Efficiency Program:** | | | | |
| | **Production** | | | | |
| | Nuclear (APS Share) | | | | |
| 2 | Nuclear Fuel | - | - | - | - |
| 3 | Reactor Vessel Head, Units 1, 2, 3 | - | - | - | - |
| 4 | Evap Pond & Reservoir Liner Replacement | - | - | - | - |
| 5 | Cooling Tower Replacement, Unit 1 | - | - | - | - |
| 6 | Rapid Refueling Package | - | - | - | - |
| 7 | Other Nuclear Power Plant Improvements - includes regulatory, safety, reliability, or efficiency projects not listed above | - | - | - | - |
| 8 | Total Nuclear | - | - | - | - |
| | Fossil (APS Share) | | | | |
| 9 | Cholla Environmental- Includes Baghouse, Scrubber, and other Environmental projects | (24) | (47) | 18 | (53) |
| 10 | Four Corners Environmental - Includes NOX abatement, particulate control, and other Environmental projects | 1 | - | 19 | 20 |
| 11 | Navajo Environmental - Includes NOX abatement and other Environmental projects | 1 | - | - | 1 |
| 12 | Other Coal Plant projects - Includes regulatory, safety, reliability, and efficiency projects at coal plants | (9) | (24) | (8) | (41) |
| 13 | Environmental Projects at Gas Plants | (2) | 1 | 3 | 2 |
| 14 | Long-Term Service Agreement Costs at Redhawk, West Phoenix | (29) | 25 | (1) | (5) |
| 15 | Other Plant projects - Includes capital costs for regulatory, safety, reliability, and efficiency projects at gas plants, and Childs/Irving Decommissioning | (3) | (14) | 7 | (10) |
| 16 | Total Fossil | (65) | (59) | 38 | (86) |
| 17 | **Total Production** | **(65)** | **(59)** | **38** | **(86)** |

Note: This forecast is included in the Direct Testimony of Donald E. Brandt (Docket No. E-01345A-08-0172) as Attachment DEB-3. The forecast provided here differs from that provided in Attachment DEB-3 only in terms of years shown. Attachment DEB-3 shows the Company's forecast for 2008-2010 as of June 2008, consistent with the Company's asking in that case. The projections shown here are for years 2009-2011, to give the background necessary to show the impact of the recent Cost Efficiency Program (which will be seen in that timeframe) on the Company's overall forecast at the time of the rate case.

**Arizona Public Service Company**
**Cost Efficiency Program Impact on Construction Expenditures Projection 2009 - 2011**
**$Millions**



| line | Transmission & Distribution | 2009 | 2010 | 2011 | 3 - yr Total |
|---|---|---|---|---|---|
| | **Transmission** | | | | |
| | Selected Major Transmission Projects | | | | |
| 18 | Palo Verde - TS5 - TS9<br>TS5 to be located northwest of White Tanks; TS9 to be located near existing Raceway substation | (47) | (30) | (86) | (163) |
| 19 | TS5 - TS1 - Palm Valley<br>TS1 to be located southwest of 195th Av & Deer Valley | (10) | (3) | 4 | (9) |
| 20 | TS9 - Pinnacle Peak 500kV | 46 | (18) | - | 28 |
| 21 | Palo Verde - North Gila 500kV | (30) | (37) | 22 | (45) |
| 22 | All Other Transmission Infrastructure Additions & Upgrades - includes Line & Substation additions & upgrades for 69kV and above voltage not listed above | (28) | (104) | (115) | (247) |
| 23 | Transmission Reliability Projects - includes Breaker, Capacitor, and Reactor projects, and other major reliability projects | 7 | (3) | - | 4 |
| 24 | Transmission relocations & emergency projects | - | - | - | - |
| 25 | Total Transmission | (62) | (195) | (175) | (432) |
| | **Distribution** | | | | |
| 26 | Distribution Infrastructure projects - includes line & substations additions & upgrades | (29) | (39) | (28) | (96) |
| 27 | Distribution Reliability Projects - includes projects for substation, overhead, and underground equipment | - | 2 | (4) | (2) |
| 28 | Other Distribution Projects - Safety, Relocation / Conversion, Emergency, and other projects | 13 | 15 | 10 | 38 |
| 29 | Subtotal, Distribution excluding Customer Construction | (16) | (22) | (22) | (60) |
| | **New Customer Construction (excl Schedule 3 CIAC)** | | | | |
| 30 | Meters (primarily AMI project) | 19 | 28 | 20 | 67 |
| 31 | Transformers | (6) | (14) | (23) | (43) |
| 32 | Service & Line Extensions | (19) | (32) | (91) | (142) |
| 33 | Street Light / Dusk-to-Dawn | 1 | 1 | - | 2 |
| 34 | Total New Customer Construction excl Schedule 3 CIAC | (5) | (17) | (94) | (116) |
| 35 | **Total Distribution excluding Schedule 3 CIAC** | (21) | (39) | (116) | (176) |
| 36 | **Total Transmission & Distribution** | (83) | (234) | (291) | (608) |

**Arizona Public Service Company**
**Cost Efficiency Program Impact on Construction Expenditures Projection 2009 - 2011**
**$Millions**



| line | General Plant | 2009 | 2010 | 2011 | 3 - yr Total |
|---|---|---|---|---|---|
| 37 | Customer Service Information systems | 6 | 7 | 7 | 20 |
| 38 | Distribution operations & work-management systems | 23 | 9 | 8 | 40 |
| 39 | All Other Info Sys Projects - Includes infrastructure additions, equipment replacement, and all other Generation, T&D, and Shared Services systems & telecom | 3 | 1 | 12 | 16 |
| 40 | Deer Valley Operations Hub | (63) | (14) | 86 | 9 |
| 41 | Facilities - Includes new service centers, upgrades of existing facilities, and replacements of mechanical equipment, plumbing, etc. at APS facilities. | (44) | (45) | (27) | (116) |
| 42 | Other General Plant | 2 | - | 4 | 6 |
| 43 | Total General Plant | (73) | (42) | 90 | (25) |
| 44 | **Total Change excluding Schedule 3 CIAC** | **(221)** | **(335)** | **(163)** | **(719)** |
| 45 | Schedule 3 CIAC | 30 | 50 | 116 | 196 |
| 46 | **Total Change including Schedule 3 CIAC** | **(191)** | **(285)** | **(47)** | **(523)** |
| 47 | **Construction Expenditure Projection as of October 2008** | **894** | **708** | **917** | **2,519** |

# Attachment 2

**Attachment 2**


## APS Construction Expenditure Projections
## 2005 Rate Case Forecast vs 2008 Rate Case Forecast
$Millions

| line | | 2005 Rate Case Forecast [A] | | | | 2008 Rate Case Forecast [B] | | | | Change | | | | Notes |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | (1) 2008 | (2) 2009 | (3) 2010 | (4) 3-yr Total | (5) 2008 | (6) 2009 | (7) 2010 | (8) 3-yr Total | (5)-(1) 2008 | (6)-(2) 2009 | (7)-(3) 2010 | (8)-(4) 3-yr Total | |
| 1 | Nuclear Fuel (APS Share) | 41 | 59 | 55 | 155 | 93 | 117 | 110 | 320 | 52 | 58 | 55 | 165 | C |
| 2 | Nuclear Plant Improvements (APS Share) | 42 | 39 | 21 | 102 | 55 | 78 | 79 | 212 | 13 | 39 | 58 | 110 | D |
| 3 | Fossil Plant Improvements (APS Share) | 179 | 191 | 138 | 508 | 231 | 190 | 181 | 602 | 52 | (1) | 43 | 94 | E |
| 4 | Transmission | 222 | 283 | 182 | 687 | 208 | 317 | 288 | 813 | (14) | 34 | 106 | 126 | F |
| 5 | Distribution, excluding Schedule 3 CIAC | 307 | 317 | 326 | 950 | 299 | 248 | 260 | 807 | (8) | (69) | (66) | (143) | G |
| 6 | General Plant - Information Systems, Facilities, Other | 133 | 134 | 123 | 390 | 162 | 194 | 154 | 510 | 29 | 60 | 31 | 120 | H |
| 7 | Total APS excluding Schedule 3 CIAC | 924 | 1,023 | 845 | 2,792 | 1,048 | 1,144 | 1,072 | 3,264 | 124 | 121 | 227 | 472 | |
| 8 | Schedule 3 CIAC | - | - | - | - | (25) | (59) | (79) | (163) | (25) | (59) | (79) | (163) | |
| 9 | **Total APS** | **924** | **1,023** | **845** | **2,792** | **1,023** | **1,085** | **993** | **3,101** | **99** | **62** | **148** | **309** | |

A The forecast provided in the 2005 Rate Case (Docket Nos. E-01345A-05-0816, E-01345A-05-0826 and E-01345A-05-0827) as Exhibit 27 was based upon August 26, 2006 projections. This forecast information was subsequently provided in the Financing Hearing (Docket No. E-01345A-06-0779), as Exhibit 4.

B The forecast provided in the 2008 Rate Case (Docket No. E-01345A-08-0172) as Attachment DEB-3 to Donald E. Brandt General Rate Case Testimony, was based on June 2008 projections.

C Changes principally due to increases in the cost of nuclear fuel.

D Changes principally due to changes in timing & scope of various plant improvement projects

E Changes principally due to changes in timing & scope of various plant improvement projects and increases to material prices

F Changes principally due to changes in timing & scope of various transmission projects and increases to material prices and right-of-way costs

G Changes principally due to recognized slower customer growth and efficiency initiative reductions, partially offset by changes in timing & scope of various distribution projects and increases in material prices

H Changes principally due to the addition of the Deer Valley Operations hub and changes in timing & scope of various facilities and information systems projects

PINNACLE WEST
CAPITAL CORPORATION

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**LAW DEPARTMENT** 2008 NOV 26 P 3: 04

**Thomas L. Mumaw**
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DOCKET CONTROL

November 26, 2008

RECEIVED

AZ CORP COMM
Director Utilities

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

Re: ***Request for Information Regarding Efforts by APS to Cut Costs; Docket No. E-01345A-08-0172***

Dear Commissioner Mayes:

In your letter of November 19, 2008, you asked for information regarding the efforts of Arizona Public Service Company ("APS" or "Company") to reduce its costs. Before responding to this request, it is important to keep in mind that the fundamental issue facing APS is that our prices do not reflect our cost of service either on a current or prospective basis. Neither the present financial crisis facing APS and its customers nor the long-term, substantial earnings shortfall that has been borne by APS shareholders are the result of a decline in productivity, reduced operational efficiency, poor reliability or lackluster customer service.

APS presently has only its third request for a base rate increase since 1991 pending before the Arizona Corporation Commission ("Commission"). That request, as you correctly note, is for $278.2 million annually, of which the Company has sought to implement $115 million (or just over 40% of the total) on an interim basis subject to refund. Even if this current base rate increase is granted in full, APS base rates will have only increased by a compounded rate of 1.2% per year since 1991, which is well below the overall rate of inflation (3.3%) present in the general economy during this same period. In fact, the cost of electricity for APS customers as a percentage of personal income has declined 22% since 1990. Thus, the Company believes that it has provided outstanding value for our customers. The Company has for years consistently requested that the Commission set rates that will recover on a timely basis only the reasonable cost of meeting the essential energy needs of customers in our service area. We regard such compensatory rates as both an economic necessity to allow APS to continue to provide reliable electricity service to the public and fully consistent with the requirements of both the Arizona and United States Constitutions.

That said, APS continuously strives to control its costs. The most recent announcements of over $500 million in additional capital spending cuts or deferrals (bringing the total to date to approximately $720 million) and $50 million in O&M reductions clearly demonstrate APS's rigorous and continuing cost management culture, a business culture that has been in effect for many years at APS. The bottom line results of this way of doing business include some remarkable statistics:

- Despite having a relatively low density service territory (a little over 20 customers per square mile compared to nearly 300 customers per square mile for TEP and SRP), APS has nearly 1000 fewer employees now compared to 20 years ago, and its customer-to-employee ratio has improved from 98 to 227 during than same period, providing an increase of 130% in efficiency per employee.

- APS fossil fuel generating plants continue to operate at the highest levels of capacity factor and availability in the industry.

- Nuclear plant performance reached industry highs during the 1997-2001 period, and thanks to the ongoing Performance Improvement Plan, is returning to that level of performance with an anticipated annual capacity factor (including refueling outages) of approximately 84% for 2008. We also expect the NRC to remove Palo Verde from Column 4 oversight sometime next year.

- The Company's introduction of computer-aided standardized designs and the use of pre-fabricated components have reduced the manpower needed to build a new substation from 6-7 workers to 3-4 workers, while at the same time reducing construction time from 2-3 months to 3-4 weeks.

- The frequency of distribution-related APS customer outages has declined 67% from 1996 through 2007. The average duration of outages has declined 16 minutes (over 15%). APS expects in 2008 to break last year's reliability record for the lowest frequency of customer outages (clear weather SAIFI), and expects to improve over last year's performance on the duration of customer outages (SAIDI).

- Despite the decrease in the workforce, APS employees have twice won the highest award in the electrical industry for inventiveness and technical innovation. No other U.S. utility has received this award more than once during this same period.

- Overall non-production O&M levels (which provide an accurate comparison between electric utilities owning various levels of generation)[1] for APS fall well below our peers, both regionally and nationally. *See* Figure 1, below.

[1] Moreover, the Commission has already audited the Company's fuel costs and power production functions and found them to be reasonable.

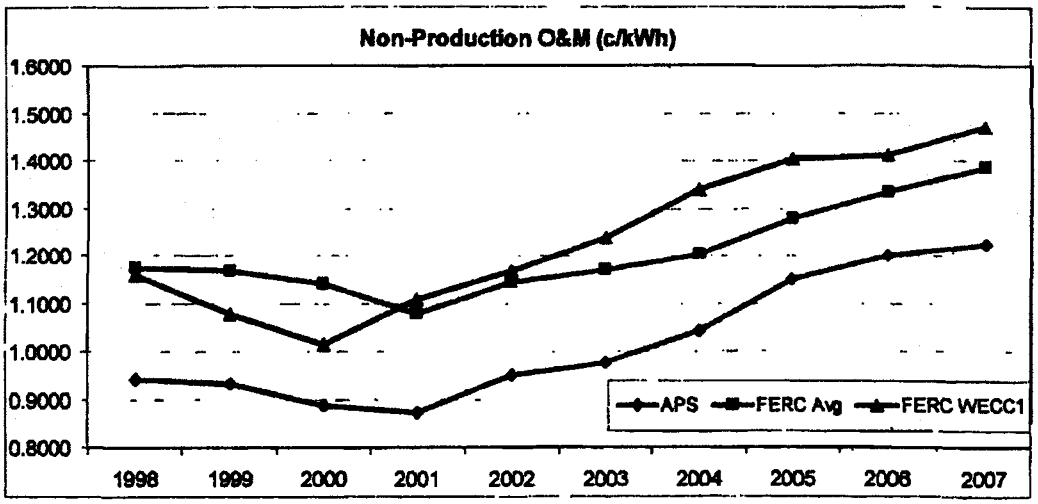


*Figure 1: APS Non-Production O&M Comparison (FERC Form 1 Data)*

You have asked whether APS considered several specific actions such as a blanket hiring "freeze," wage and salary freezes, and minimizing pay increases. Although the Company has considered many potential options for managing costs, to implement the measures cited in your letter would be harmful to both our short- and long-term operational performance, and would be counter to our customers' best interests. In fact, APS does not know of any comparable utility companies that have halted the hiring of necessary personnel, instituted blanket wage and salary freezes, or declined to pay employees appropriate compensation. Even in those "unregulated" companies characterized by failed business models and ineffective risk management (such as AIG or Lehman Brothers), these types of actions accompany a massive if not total reduction in services or reductions in output or both. Unlike these businesses, APS cannot pursue such value-destroying policies and practices, and due to its legal obligation to serve, APS cannot simply cut back on core services or output.

In a detailed letter from Jack Davis to the Commission dated August 1, 2006, Mr. Davis provided an exhaustive discussion of APS efforts to manage its costs over the years. These efforts have continued. Mr. Davis specifically indicated in that letter that the creation of new job positions at APS could only take place with his authorization as President of APS. Since Don Brandt has become President of the Company, he has maintained this policy. However, a complete cessation of all hiring would run counter to the best interests of the Company and its customers. The electric industry's workforce is rapidly aging, and there is an acute shortage of qualified utility employees nationwide. For this reason alone, APS must retain the ability to attract and retain such employees when the opportunity presents itself. Moreover, we must maintain critical positions at all times, and the training of the next generation of employees to the highest standards must continue.

The provisions of the collective bargaining agreements covering many APS employees render the limitation, let alone the elimination, of pay increases an impossibility. Although not subject to the same contractual agreements, but for the same reasons I discussed with regard to the concept of a hiring "freeze," APS must remain competitive in the compensation it pays for both management and non-management personnel. To do less would sacrifice competency, professionalism and long-term efficiencies for minimal and, perhaps, illusory short-term gains. APS compensation levels are reasonable and comparable to peer companies, particularly given the demand for qualified utility personnel that we are seeing in our industry today.

Your letter also refers to the potential reduction or elimination of "management bonuses." The term "bonus" is actually not descriptive of the Company's incentive program. A "bonus" implies gratuitous additional compensation in excess of what the market requires to attract and retain employees at all levels. In that sense, APS pays no "bonuses." APS, like most utilities and many non-utility businesses, does have a component of each employee's compensation that falls under the heading of "at risk." "At risk" means that the level of this element of compensation depends upon performance – both individually and collectively. Thus, we and others refer to such compensation as "incentive" pay because it provides a direct and measurable incentive to achieve or surpass critical performance measures affecting the Company's operations. APS's outside compensation expert testified, without refutation by any other party, in the previous general rate case about the critical importance of the "at risk" component of overall employee compensation. Without this element, the Company could not compete for qualified executives, managers, and non-management employees with other companies using such compensation factors. The Commission recognized in the last APS rate case that these critical performance measures redounded in very large part to our customers' benefit, and thus cash incentive compensation should properly be included in APS's cost of service.

Allow me now to address some of the specific information you have requested:

1. Both the federal affairs and the public affairs groups are at Pinnacle West, and costs are allocated to APS and other affiliates. Lobbying-related expenditures for 2008 will total approximately $2.4 million, from a total federal and public affairs budget of $3.8 million. As you are no doubt aware, the Commission determined in the Company's last general rate case to effectively split these costs "50/50" between customers and shareholders. However, lobbying efforts have saved APS customers far more in the form of favorable legislation and administrative relief than even the full cost of such efforts. APS has previously provided significant detail on specific lobbying efforts that benefited customers in a November 26, 2007 letter to you from Meghan Grabel. In 2008, these efforts have focused on federal matters such as the extension of tax credits for renewable generation and state matters such as protecting our customers' interests in the Western Climate Initiative and working to try to minimize adverse impacts of state budget cuts on APS, its customers and the regulatory process in Arizona.

2. All employee incentive program compensation expended in 2008 has already been paid out. The APS expense was $6.7 million for officers and other senior management employees.

3. The Company's advertising budget anticipates that approximately $2.7 million of costs will be charged to the applicable regulatory accounts during 2008. This amount covers messaging solely around energy efficiency, conservation, renewables (other than that directly funded through the RES), and the "green choice" rate program. In addition, the DSM programs approved by the Commission have a marketing component, which includes approximately $1.2 million for advertising. Advertising related to the RES is separately budgeted and approved by the Commission as part of the overall category of RES marketing and outreach. For 2008, this RES-related marketing and outreach budget was $2.5 million. There is also some APS advertising related to safety messages. This safety-related advertising budget is about $200,000 for 2008. Finally, there is roughly $5000 of APS signage connected to charitable and civic events. That small amount is recorded "below-the-line" and paid for by APS shareholders. APS has no sports sponsorship costs for 2008.

4. The cost management efforts of APS have resulted in the reduction of some 550 positions. Of these, 375 positions were full-time employees, including 26 management positions, and 175 were contract employees.

5. The APS dividend to Pinnacle West for 2008 is $170 million. The dividend that APS has paid has not changed in well over a decade not withstanding equity infusions from Pinnacle West of over $700 million. Since 1996, this represents at least a 27% decline in the real (inflation adjusted) APS dividend to Pinnacle West and over a 50% decline in the dividend as a percentage of Pinnacle West's equity investment in APS.

APS understands the regulatory compact it has with the Commission. In the recent past, the Commission has examined the Company's operations and service quality in general rate cases, including the current proceeding in which Commission Staff alone has served some 25 sets of Data Requests (nearly 600 questions, often with numerous subparts) upon APS. The Commission has retained consultants to conduct specialized audits of fuel and power procurement and management, power plant operations, and hedging. Commission Staff itself has similarly reviewed APS's management of its financing costs. Neither Staff nor its consultants determined that APS managed these activities in an imprudent manner.

The capital and O&M cost savings announced during the second and third quarter conference calls focused primarily on 2009 and beyond. However, as APS has discussed in the Company's general rate case testimony, APS implemented some $14 million in O&M savings in 2008, including reductions in lobbying, advertising and communications costs. These cost savings also reflected reduced medical expenses resulting from changes to employee health care plans and reprioritizing, deferring or improving the efficiency of a variety of operations and maintenance work. Also, the initially-announced $200 million in capital expenditure reductions included work planned in 2008 as well as subsequent years.

APS understands the need to maintain customer service to the greatest extent possible. Certainly, this means balancing the level of service provided with the costs associated with such service levels. However, APS does not want short-term considerations to undermine an established record of improving customer service and satisfaction. Neither should cost-cutting be asked to come at the expense of environmental stewardship, our communities or the implementation of technological innovations such as advanced metering infrastructure. Each of these elements has an important call on the Company's responsibility as Arizona's largest electric utility.

While we understand that price increases are unpopular, including those driven by fuel costs outside the control of APS and this Commission, APS has received high ratings in customer satisfaction. Over the last several years, APS has ranked among the highest investor owned utilities in the Western United States in J.D. Power studies of customer satisfaction. Certainly, a major commitment to customer-friendly technology has enhanced customer satisfaction, such as installing over 150,000 "smart" meters, designing a state of the art website (ranked the 6th best in North America by E-Source), and demonstrating its overall dedication to the best in information technology (ranked 1st by the technology trade publication *Information Week*). APS employees work hard to support our communities, including thousands of volunteer hours donated to a wide array of causes and activities. APS's general efforts have benefited economic development in at least 40 separate Arizona communities or regions, promoted educational opportunities for Arizona students, and provided support to environmental and other important community projects. Also, in 2008, the Better Business Bureau awarded APS the Business Ethics Award.

Environmental stewardship informs many of the actions undertaken by APS. Beginning with its becoming the first utility to join the Coalition for Environmentally Responsible Economies in 1994 to its 2006 Climate Protection Award by the EPA, APS has become a recognized leader in the field of environmental and economic sustainability. Indeed, APS can claim status as the only Arizona company and only one of two U.S. utilities to rank among the world's 100 Most Sustainable Corporations. It enjoys a AAA rating from Innovest as being at the top of its industry in economic innovation, as well as concern for the environment and the community. APS continues to demonstrate its long-standing concern for the environment by providing its customers with the option of purchasing energy generated from renewable sources of electricity and by conserving electricity through energy efficiency and demand response.

With this Commission's support and policies, APS has become a leader in renewable resources particularly after the Commission's enactment of the Renewable Energy Standard ("RES"). With advent of the RES, however, APS has increased its renewable portfolio over thirty-fold since just 2005. With Solana and similar facilities and assuming the Company has the financial capability, APS has a goal of producing nearly half of its incremental needs in the years ahead through renewable resources. APS customers can contribute directly through both participation in distributed renewable energy projects and by subscribing to one of the Company's "green" power pricing options.

Again with Commission support, APS has instituted a number of cost-effective demand side management and energy efficiency programs. Just through 2007, these will result in 1.7 million MWH in lifetime energy savings. Notwithstanding the adverse impacts to the Company's financial performance from implementing effective energy efficiency programs, APS has increased its 2008 spending on energy efficiency by some 20% over 2007 levels, and for the second straight year, the EPA and the Department of Energy named APS an Energy Star Partner. Assuming continued regulatory support, APS hopes to increase its commitment to at least $25 million per year beginning in 2009. Recently, APS submitted for Commission approval a demand response program for general service customers. If approved, this will become the first of such programs, as APS anticipates providing an ever-increasing share of its additional capacity and energy needs through customer-based programs for demand reduction and energy efficiency.

We hope that the information contained in this letter responds to your requests and also helps the Commission view our present circumstances in an appropriate context. Challenging times often call for difficult decisions. When dealing with a vital service such as electricity, we need to avoid marginal solutions that may result in compromising important long-term values such as efficiency, reliability, safety, the environment and service to our communities. We take all of these factors into consideration each and every day in all of our business decisions, never losing sight of the long-term objectives we must pursue. APS looks forward to working with the Commission to providing the best possible service to our over one million customers.

Sincerely,

Thomas L. Mumaw

Thomas L. Mumaw

cc: Mike Gleason, Chairman
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# DIRECT SETTLEMENT TESTIMONY OF BARBARA D. LOCKWOOD

**On Behalf of Arizona Public Service Company**

**Docket No. E-01345A-08-0172**

July 1, 2009

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**DIRECT TESTIMONY OF BARBARA D. LOCKWOOD**
**ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY**
**(Docket No. E-01345A-08-0172)**

I. <u>INTRODUCTION</u>

**Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

A. My name is Barbara D. Lockwood. 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 the Director of Renewable Energy. In that position, I am responsible for APS's renewable energy programs including generation planning, customer programs and policy.

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

A. I hold a Bachelor of Science degree in Chemical Engineering from Clemson University and a Master of Science degree in Environmental Engineering from Georgia Institute of Technology. I am a registered professional chemical engineer in Arizona, and I began my career in the chemical industry at E.I. DuPont de Nemours ("DuPont") in various engineering and management roles. Subsequent to DuPont, I worked in the consulting field and managed diverse projects for national clients across the United States. I have been with APS since 1999.

**Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

A. My testimony will address the settlement provisions related to Renewable Energy, specifically Section XV of the Settlement Agreement. My testimony is organized into four primary areas: (1) the overall renewable energy goals; (2) in-state wind and photovoltaic renewable generation procurement related provisions; (3) distributed energy related provisions; and (4) cost recovery.

## II. SUMMARY

**Q. WOULD YOU PLEASE SUMMARIZE YOUR TESTIMONY?**

A. One of the goals of the Settlement Agreement is to advance sustainable decisions related to Arizona's energy future. APS strongly supports the Settlement Agreement and continues to promote renewable energy development and implement initiatives that go beyond the requirements in the Renewable Energy Standard ("RES") Rules. Under the Settlement Agreement, APS will acquire by the end of 2015 new renewable resources that provide 1,700 gigawatt hours ("GWh") of renewable energy annually. Along with existing commitments, this is double the amount of energy required under the RES. In meeting that objective, APS will develop a plan to adopt a utility scale photovoltaic project, issue a request for proposal ("RFP") for an in-state wind generation project, develop a proposal for distributed solar projects for Arizona K-12 schools, and develop a proposal for distributed solar energy projects aimed at governmental institutions. The Settlement Agreement also provides for timely cost recovery through existing rate mechanisms.

**Q. WILL YOU BE ADDRESSING THE PROVISIONS IN THE SETTLEMENT AGREEMENT RELATED TO THE CONSTRUCTION OF RENEWABLE TRANSMISSION?**

A. No. APS Witness Jeff Guldner will be addressing all renewable transmission provisions of the Settlement Agreement.

## III. RENEWABLE ENERGY GOALS

**Q. DOES APS SUPPORT THE COMMISSION'S RES?**

A. Yes. APS believes the standard has done much to further the application of renewable resources in the state, encourage the development of the renewable resource industry to supply such resources, and provide some regulatory clarity to utilities and market participants. The Company does not, however, believe it is appropriate or necessary to adopt the current RES in the Settlement Agreement or in this Docket. Adopting the RES in this proceeding could create the possibility of conflicting requirements in the future and could limit the ability of the Commission to make certain changes in future RES Implementation Plans.

**Q. PLEASE DESCRIBE THE RENEWABLE ENERGY GOAL IN THE SETTLEMENT AGREEMENT.**

A. Under the Settlement Agreement, the Company will make its best efforts to acquire new renewable energy resources with annual generation or savings of 1,700 GWh annually by December 31, 2015. These new renewable resources are in addition to existing resources or commitments as of the end of 2008 as identified in APS's 2008 annual RES Compliance Report[1] and will include a mix of distributed and non-distributed resources.[2]

**Q. HOW DOES THIS GOAL BENEFIT THE CUSTOMER?**

A. As a result of the Settlement Agreement, the Company has now made a commitment to a specific result – namely, the acquisition of 1,700 GWh of

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[1] Docket No. E-01345A-07-0468 (April 1, 2009).

[2] The Company's recently filed request for approval of a Power Purchase Agreement with the proposed CSP resource Starwood Solar I will, when approved, contribute approximately 900,000 MWhs toward this goal (Docket No. E-01345A-09-0261, filed May 22, 2009).

renewable energy resources on an annual basis by 2015. The Settlement Agreement provides a balance between specific commitments and the Company's general plan to include renewable resources as a significant part of its future resource needs.

Additionally, as set forth in Paragraph 15.8 of the Settlement Agreement, the Company is obligated to follow through with this acquisition of 1,700,000 megawatt-hours ("MWh") of renewable energy by 2015 regardless of the outcome of any judicial challenge to the RES rules. This paragraph assures both customers and the Commission that APS will continue to pursue feasible renewable energy as the Company acquires resources to meet future load.

**Q. PLEASE EXPLAIN WHY THE 1,700 GWH RENEWABLE ENERGY TARGET ADOPTED BY THE SETTLEMENT AGREEMENT IS REASONABLE?**

A. The overall energy target is consistent with APS's long-term renewable resource acquisition plans that were included as part of APS's Resource Plan Report[3]. In addition, the renewable energy requirement will exceed the requirements under the RES. Under current estimates, the new renewable acquisitions, in combination with existing renewable commitments are approximately the equivalent of 10% of retail sales by the end of 2015, or double the RES requirement of 5%.

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[3] Docket No. E-01345A-09-0037 (January 29, 2009), Appendix 1.

**Q. HOW ARE RENEWABLE RESOURCES BEING DEFINED?**

A. Renewable resources are being defined consistent with the definition of "Eligible Renewable Energy Resources" included in the RES in A.A.C. R14-2-1802.

**Q. ARE THERE ANY REPORTING REQUIREMENTS IN THE SETTLEMENT AGREEMENT REGARDING RENEWABLE ENERGY?**

A. Yes. APS will report to the Commission on the Company's plans and progress toward acquiring these new resources in APS's annual RES Implementation Plans, RES Compliance Reports, and in future resource planning filings. Aligning the Settlement renewable energy reporting requirements with the existing RES reporting provides consistency and efficiency. Should there be any expected delays or shortfalls in meeting these renewable energy requirements, APS will also notify the Commission consistent with this reporting requirement.

## IV. <u>WIND AND PHOTOVOLTAIC GENERATION</u>

**Q. PLEASE DESCRIBE THE SETTLEMENT PROVISIONS RELATED TO WIND AND PHOTOVOLTAIC ("PV") GENERATION PROCUREMENT.**

A. The Settlement includes an in-state wind requirement. Under this provision, APS will issue an RFP for in-state wind generation within 90 days of Commission approval of the Settlement. After evaluating the proposals, within 180 days of the issuance of this RFP the Company will file a request for Commission approval of one or more of these projects and will proceed as quickly as is feasible with any authorized wind generation project.

Under the PV requirement, APS will file for Commission consideration a plan for implementing a utility scale PV project within 120 days of Commission approval of the Settlement. The project will have a construction initiation date no later than 18 months from the date of APS's filing of the plan. This commitment is in addition to the Concentrating Solar Power ("CSP") project, Starwood Solar I, purchased power agreement that was recently filed with the Commission for approval.

**Q. WHAT GUIDELINES DOES THE COMPANY FOLLOW TO ENSURE THAT THE PROCUREMENT PROCESS IS FAIR AND UNBIASED?**

A. As part of the Company's procurement strategy, and pursuant to the REST Rules,[4] APS has had its Renewable Energy Competitive Procurement Procedures ("Procurement Procedures") reviewed and certified by an independent auditor.[5] The Procurement Procedures identify the policies and procedures APS will use to procure renewable energy through both RFP and bilateral purchase approaches. APS utilizes these procedures as part of its procurement strategy and has adopted the use of an independent third party to review the Company's RFP process to assess whether it was conducted in a fair and unbiased manner. Since the Procurement Procedures were certified, APS has issued four renewable solicitations and procured over 2,100 GWh in renewable energy.

**Q. IN WHAT MANNER WILL APS SEEK COMMISSION APPROVAL FOR EACH OF THESE PROJECTS?**

A. As discussed later in this testimony, APS will file for Commission approval of these resources through either 1) a separate application, 2) as part of the Company's annual REST Implementation Plan, or 3) as part of the Company's Resource Plan.

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[4] A.A.C. R14-2-1812(B)(6).

[5] 2007 Renewable Energy Procurement Solicitation Certification FINAL REPORT, Presented to Arizona Public Service Company, April 10, 2007, Navigant Consulting.

V. DISTRIBUTED ENERGY

**Q. PLEASE DESCRIBE THE SETTLEMENT PROVISIONS RELATED TO DISTRIBUTED ENERGY.**

A. The Settlement Agreement includes provisions for the installation of distributed on-site solar energy at grades K through 12 of public (including charter) schools ("Schools Solar Program") resulting in 50,000 megawatt hours of annual energy generation or savings within 36 months of Commission approval of the Schools Solar Program.

The Settlement Agreement also includes a provision for APS to file a distributed solar energy program for Governmental Institutions. Neither of these two groups of customers can take advantage of tax credits, which impacts their ability to participate in the current program. Both programs have a goal to help eliminate up-front customer costs, and they will include distributed solar technologies including photovoltaics, solar water heating, and daylighting.

**Q. WHAT TYPE OF CONSIDERATIONS WILL BE TAKEN INTO ACCOUNT WHEN PRIORITIZING PROJECTS UNDER THE SCHOOLS PROGRAM?**

A. APS will collaborate with the School Facilities Board ("SFB") in determining the priority of projects. In the process, APS and the SFB will give consideration to the assessed valuation of the school district, participation in the National School Lunch Program, geographic diversity, and the need for the project.

**Q. HOW WILL THE COMPANY APPLY FOR COMMISSION APPROVAL OF THE SCHOOLS PROGRAM AND THE GOVERNMENTAL INSTITUTIONS PROGRAM?**

A. APS will file with the Commission its Schools Solar Program and Governmental Institutions proposed program under a new docket number within 120 days of a Commission order approving the Settlement. Under the Schools Solar Program the application would include an estimate of costs associated with the program, a proposed method for cost recovery as provided for in Section XV of this Agreement, and APS's proposal for counting the energy towards APS RES requirements. In designing the program, APS will consider as part of its options a request for proposal by developers to implement and install solar energy systems on multiple schools such that schools pay no up-front costs.

Under the Schools Solar Program, APS will provide an opportunity for interested stakeholders including school representatives and solar industry representatives to provide input into the Company's proposed School Solar Program. Under the Governmental Institutions Program, APS will also provide an opportunity for stakeholder input on the proposed Program and the Program may be filed concurrently with the Schools Solar Program.

**Q. DOES APS HAVE EXPERIENCE WORKING WITH THE SCHOOLS TO ENCOURAGE RENEWABLE ENERGY INSTALLATIONS UNDER THE COMPANY'S EXISTING RENWABLE PROGRAM?**

A. Yes. APS has worked with schools in the development of renewable resources through school participation in the Company's renewable energy incentive programs. As well, schools have bid into the RFP processes for distributed renewable projects. The Company has also worked with the Schools and related organizations through the implementation of energy efficiency measures.

**Q. WOULD SCHOOLS RECEIVING FEDERAL STIMULUS FUNDING UNDER THE AMERICAN RECOVERY AND REINVESTMENT ACT BE COUNTED TOWARDS THE SCHOOL SOLAR PROGRAM GOAL?**

A. Yes. School programs executed with RES funds and leveraged with federal stimulus funding would qualify toward meeting the RES program goal.

**Q. HAS THE COMPANY REVIEWED CALIFORNIA'S "FEED-IN" TARIFF PROGRAM AS MENTIONED IN CHAIRMAN MAYES' LETTER TO THE PARTIES DATED JUNE 9, 2009?**

A. Yes. California Public Utilities Commission Resolution E-4137 authorizes utilities to purchase eligible renewable generation from public water and wastewater facilities. Briefly, the resolution approved tariffs which will offer set market prices, by time-of-use hours, for a period of 10, 15 or 20 years for the sale of renewable generation to the utility from eligible facilities. The program is available until the statewide capacity of these purchases reaches 250 megawatts ("MW"). Projects are capped at either 1 MW or 1.5 MW depending on the utility.

**Q. WOULD THE COMPANY SUPPORT SUCH A PROGRAM?**

A. Although APS does not believe a feed-in tariff is the optimal approach for encouraging customer investment in renewable energy systems, APS would not oppose a pilot program for this type of renewable purchase program for small renewable generation projects.[6] As indicated, APS believes that procuring this type of renewable energy would likely be more costly (and therefore of lesser benefit to APS customers) than if acquired through the Company's established competitive solicitation process. For example, costs proposed in responses to the Company's 2008 distributed energy RFP are approximately half the price of APS's standard incentive program. Additionally, APS recently issued an RFP requesting renewable projects of similar size, and is currently evaluating the

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[6] It is important to note, however, that the kWh's generated by this type of project will not qualify to be counted toward a Distributed Renewable Energy Requirement as the RES rules are written today.

responses to that RFP. The results of this RFP will be communicated to the Commission in APS's 2009 Compliance Report.

If the Commission would like to explore this type of program further, APS suggests that it be considered in the renewable energy Implementation Plan process, thereby giving all stakeholders an opportunity to have input to the program design and consider broader program implications.

**Q. HOW MANY MW SHOULD BE TARGETED UNDER SUCH A "FEED-IN" PROGRAM?**

A. The objectives of this program would need to be clearly defined to establish MW targets. If the goal of such a program were to encourage additional distributed generation, the energy requirements under the distributed energy portion of the RES could provide guidance. Another consideration in determining the size of the program would be the amount of funding required.

As mentioned, it would be productive to discuss this potential program in the RES Implementation Plan process in conjunction with all other RES program elements.

**Q. IS THERE A NEED TO ESTABLISH A "CARBON TRUST FUND" AS SUGGESTED BY CHAIRMAN MAYES?**

A. APS believes a "carbon trust fund" is not necessary. Today, the Company does not systematically "bank" carbon credits as a separate asset. Such credits are included in Renewable Energy Credits ("RECs") that the Company currently banks to be used to satisfy the long-term RES requirements. To date, the Company has not sold any RECs; however, if those credits were to be sold, the funds generated through such a sale would be returned or credited to the customer through the RES or another appropriate mechanism. Therefore, the

Company believes that a trust fund for carbon credits would add an unnecessary layer of complexity and cost to the acquisition of renewable energy resources.

## VI. COST RECOVERY

**Q. HOW WILL THE COMPANY RECOVER COSTS ASSOCIATED WITH THE RENEWABLE PROVISIONS IN THE SETTLEMENT AGREEMENT?**

A. As provided for in Section XV of the Agreement, APS will recover all prudent expenses incurred for renewable energy provisions under the Settlement through the Power Supply Adjustor ("PSA"), RES, or the Transmission Cost Adjustor ("TCA"). Depending on project scope and cost, APS will file for Commission approval of these resources as a separate application, as part of the Company's annual RES Implementation Plan, or as part of the Company's Resource Plan. APS will evaluate the appropriate cost recovery mechanism on a case-by-case basis; but as a general proposition, the recovery of renewable energy purchased power agreements would be split, as is presently the case, between the RES and the PSA. Program costs such as rebates, financing cost buy-downs, and administrative costs would be recovered through the RES. Transmission related costs would flow through the TCA.

**Q. WILL CAPITAL CARRYING COSTS BE RECOVERABLE UNDER THE AGREEMENT?**

A. Yes. Prudently incurred program expenses related to renewables in the Settlement Agreement will include capital carrying costs of any capital investments made by APS, including depreciation expenses at rates established by the Commission, property taxes, and a return on both debt and equity at the pre-tax weighted average cost of capital.

**Q. IS THE TOTAL COST ASSOCIATED WITH THE RENEWABLE ENERGY PROVISION CONTAINED IN THE AGREEMENT IDENTIFIABLE AT THIS TIME?**

A. No. The total cost to implement the provisions of the Settlement Agreement are unknown at this time and will depend on many different variables including the types of programs that are ultimately adopted by the Commission. The Commission will have an opportunity to review these costs as APS comes to Commission for approval of the resource acquisition or renewable energy programs adopted under the Settlement Agreement.

## VII. CONCLUSION

**Q. DO YOU HAVE ANY CONCLUDING REMARKS?**

A. Advancing sustainable decisions relating to Arizona's energy future is a goal of this Settlement Agreement. Under the Agreement, by the end of 2015, APS will acquire new resources annually providing 1,700 GWh of renewable energy; doubling the amount of energy required under the RES Rules. To meet this requirement, APS will develop a plan to adopt a utility scale photovoltaic project, issue a RFP for an in-state wind generation project, develop a proposal for distributed solar projects for Arizona K-12 schools, and develop a proposal for distributed energy projects aimed at governmental institutions. The Agreement also acknowledges the Company's need for timely recovery of the costs related to these projects, and includes a process by which these costs can be recovered through existing rate mechanisms. APS continues to promote renewable energy development and implement initiatives extending beyond the requirements set forth by the RES Rules and strongly supports this Settlement Agreement.

**Q. DOES THAT CONCLUDE YOUR DIRECT TESTIMONY?**

A. Yes.

# DIRECT SETTLEMENT TESTIMONY OF JAMES M. WONTOR

## On Behalf of Arizona Public Service Company

## Docket No. E-01345A-08-0172

July 1, 2009

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**DIRECT SETTLEMENT TESTIMONY OF JAMES M. WONTOR ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY (Docket No. E-01345A-08-0172)**

I. INTRODUCTION

**Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS**

A. My name is James M. Wontor. My business address is 400 N. 5th Street, Phoenix, Arizona, 85004.

**Q. WHAT IS YOUR POSITION WITH ARIZONA PUBLIC SERVICE COMPANY?**

A. I am manager of the Demand-Side Management Team for Arizona Public Service Company ("APS" or "Company"). In that capacity, I manage the planning and implementation of all of the Company's energy efficiency programs.

**Q. WHAT IS YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND?**

A. I hold a Masters Degree in Business Statistics from Arizona State University and a Bachelors Degree in Business Management from the University of Montana. I currently manage the Demand Side Management ("DSM") Programs for APS. These programs include both the Residential and Non-Residential energy efficiency programs, as well as the Commercial and Industrial demand response program. I am responsible for the design and implementation of all DSM programs, as well as the regulatory compliance reporting for these programs. I have held this position since September of 2007.

Prior to that time, I served as Manager of the Company's Load Forecasting function for 6 years, where I was responsible for preparing the Company's long range forecast of electric customers, sales, and revenues, as well as monitoring both the U.S. and Arizona economies.

My experience also includes 3 years as Director of Customer Care for APS Energy Services, the deregulated subsidiary of Pinnacle West Capital Corporation. In that role, I directed the metering and billing aspects of providing competitive energy service to business customers in both Arizona and California. Prior to that, I was Manager of Customer Research for APS; doing both market and load research with electric customers throughout the state of Arizona.

**Q. WHAT IS THE PURPOSE OF YOUR DIRECT TESTIMONY?**

A. The purpose of my Direct Settlement Testimony is to address the provisions outlined in the Joint Parties' Settlement Agreement ("Settlement") related to the Company's DSM endeavors. Specifically, my testimony describes four DSM-related areas in the Settlement: 1) the Energy Efficiency ("EE") savings goals for 2010 to 2012; 2) the 2010 Energy Efficiency Implementation Plan; 3) the enhancements to APS's current energy efficiency portfolio that will be implemented as a result of the Settlement; and 4) the estimated program costs and recovery of program costs and incentives through a modified DSM Adjustment Charge ("DSMAC").

## II. SUMMARY

**Q. PLEASE SUMMARIZE YOUR DIRECT TESTIMONY.**

A. Through this Settlement, Arizona and APS are taking another major step forward in advancing Arizona's sustainable energy future through the enhancement of DSM programs and measures. This Settlement establishes the first energy savings goals for any Arizona utility, a step that further integrates energy efficiency into the portfolio of resources that APS uses to serve the energy needs of its customers. The energy savings goals embodied in the Settlement modify the current approach to DSM implementation, which is now based on annual spending targets. The annual savings goals begin in 2010 and will accumulate to an overall savings of approximately 3.75% of the Company's total energy resources needed to meet retail load in 2012.

Concurrent with these aggressive energy efficiency goals, the Settlement also modifies the current DSM performance incentive. The proposed incentive encourages performance over and above the annual efficiency savings goals by offering increased incentives as the goals are met and exceeded. It also provides for reduced incentives if the savings goals are not met. The proposed performance incentive is calculated as a percent share of benefits delivered to customers, but it is also capped at a percent of program cost to ensure certainty.

Meeting these higher efficiency targets will clearly require enhancement to some current DSM programs, as well as the implementation of new energy saving measures. The proposed program enhancements include the following:

- Residential High Performance New Homes
- Residential Existing Home Performance
- Low Income Weatherization
- Non-Residential High Performance New Construction
- Non-Residential Customer Repayment Financing
- Schools Program Target
- Large Customer Self-Direction

To implement these and future program enhancements in an efficient and timely manner, the Settlement requires APS to submit an annual Energy Efficiency Implementation Plan for Commission consideration, which will include proposed programs along with the estimated funding levels needed to reach the proposed energy savings targets and a proposed DSMAC rate to achieve such funding.

The Signatories to this Settlement also have agreed that it is reasonable to modify APS's DSMAC in order to achieve more current recovery of program costs, similar to the DSM adjustment mechanism the Commission has approved for Tucson Electric Power Company. This change is an important first step in addressing the regulatory challenges associated with increasing the energy efficiency impacts that are inherent for a regulated utility.

## III. <u>ENERGY EFFICIENCY SAVINGS GOALS AND PERFORMANCE INCENTIVE</u>

**Q. PLEASE EXPLAIN THE ENERGY EFFICIENCY SAVINGS GOALS CALLED FOR UNDER TERMS OF THE SETTLEMENT?**

A. The goals establish a percent of energy resource needs that should be met through the implementation of energy efficiency measures. Stated in another way, a certain percentage of customers' energy needs will be served through efficiency savings, rather than from any power generating source. If adopted as part of this Settlement, the goals represent the first such energy-based efficiency targets established for any Arizona utility.

**Q. WHAT ARE THE SPECIFIC ENERGY EFFICIENCY SAVINGS GOALS THAT ARE ESTABLISHED IN THE SETTLEMENT?**

A. The proposed cumulative MWh savings from energy efficiency programs for 2010-2012 is 1,210,000 MWhs. Listed below are the annual incremental savings goals for each of those years and the percent of energy resource needs they represent.

| | Annual[1] Savings | Percent of Total Energy Resources |
|---|---|---|
| 2010: | 320,000 MWhs | 1.00% |
| 2011: | 400,000 MWhs | 1.25% |
| 2012: | 490,000 MWhs | 1.50% |
| 3-Year Total: | 1,210,000 MWhs | 3.75% |

**Q. HOW DO THOSE TARGETS COMPARE TO WHAT APS HAS ALREADY ACHIEVED WITH ITS ENERGY EFFICIENCY PROGRAMS OR TO WHAT OTHER STATES ARE DOING?**

In 2008, APS achieved net savings of approximately 254,000 MWh from its energy efficiency program portfolio. The target of 320,000 MWh in 2010 represents a 26% increase over the level achieved in 2008 and the 490,000 MWh target for 2012 represents a near doubling of the anticipated annual program impacts under the status quo. Cumulatively, the goal of 1,210,000 MWhs from 2010 to 2012 is a significant increase over the 565,000 MWhs that have been saved from 2005 to 2008.

In regards to the achievements of other states, I have not conducted my own independent review of the various energy efficiency programs. However, according to a March 2009 report by the American Council for an Energy-Efficient Economy, the 14 "top states" in energy efficiency performance had a median savings of 0.7% of their MWh sales in 2007. Note that a percent of sales figure is less than the percent of total energy resources target used in the

[1] These annual MWh savings will result in 1) an estimated $1.1 billion reduction in program participant total electric bills over the life of the measures installed and 2) reduced CO2 emissions by approximately 6 million tons.

Settlement. The annual targets established in the Settlement of achieving 1.00%, 1.25%, and 1.50% of total energy resources in 2010, 2011, and 2012, respectively, is significantly higher than the median for these leading states.

**Q. HOW DO THE ENERGY EFFICIENCY GOALS DIFFER FROM WHAT APS CURRENTLY HAS AS ANNUAL TARGETS?**

A. The savings goals represent a significant shift away from the emphasis on the annual DSM spending budget that has existed since 2005. Currently, the Commission sets annual spending targets for APS, and the Company is tasked with implementing the most cost effective DSM that can be achieved within that budget. The establishment of energy savings goals modifies this approach by requiring that DSM be driven by meeting the energy savings goal each year and then estimating the program budget necessary to achieve the goal.

**Q. HOW DO THE SAVINGS GOALS IN THE SETTLEMENT COMPARE TO WHAT APS EXPECTED TO ACHIEVE IN THE ABSENCE OF SPECIFIC GOALS IN THE SETTLEMENT?**

A. In the absence of energy savings goals in the Settlement, APS identified in its Resource Plan Report filing on January 29, 2009 (Docket No. E-01345A-09-0037), a possible action plan for implementing a cost effective level of energy efficiency based on known costs and technology. The targets set forth in the Settlement accelerate the level of energy savings identified in APS's Resource Plan by approximately four years.

**Q. HOW DO THE REQUIREMENTS OF THE SETTLEMENT AGREEMENT AFFECT THE ONGOING GENERIC PROCEEDING ON ENERGY EFFICIENCY IN DOCKET E-00000J-08-0314?**

A. Currently there is an energy efficiency rule-making process under way for Arizona which would include an energy efficiency standard, but acceptance of this Settlement Agreement would establish the first ever energy efficiency goals for Arizona, a goal that would be in place regardless of the outcome of the current Commission rulemaking process. If, however, a higher energy efficiency savings standard was adopted in the rule making process, then it would supersede the proposed savings goals in the Settlement.

**Q. HOW DOES THE AGREEMENT CHANGE THE CURRENT PERFORMANCE INCENTIVES FOR APS?**

A. The performance incentive under this agreement has been modified to better align the incentives with the goals. The Settlement provides for a tiered performance incentive that increases as higher percentages of the goal are reached or exceeded. As illustrated in Table A on the next page, the first performance incentive tier begins if the Company achieves at least 85% of the annual goal. If the Company achieves savings below 85% of the goal, then no performance incentive would be earned. Above the 85% threshold, the performance incentive increases as a larger portion of the goal is achieved and it reaches its maximum if APS achieves over 125% of the annual goal. At each performance achievement level, the performance incentive is calculated as a percent of net benefits to the customer and capped at a percent of the program costs. For example, if the annual savings goal was exactly achieved, the performance incentive would be 7% of net benefits, capped at 14% of program costs. In contrast, the current incentive structure is 10% of net benefits capped at 10% of program costs, regardless of the level of savings achieved. Thus, this new incentive structure requires APS to focus on programs with the highest net benefits to APS customers if it wishes to maximize its potential incentive payments.

**TABLE A**

| Achievement Relative to the Energy Efficiency Goal | Performance Incentive as % of Net Benefits | Performance Incentive Capped at % of Program Costs |
|---|---|---|
| Less than 85% | 0% | 0% |
| 85% to 95% | 6% | 12% |
| 96% to 105% | 7% | 14% |
| 106% to 115% | 8% | 16% |
| 116% to 125% | 9% | 18% |
| Above 125% | 10% | 20% |

IV. 2010 ENERGY EFFICIENCY IMPLEMENTATION PLAN

**Q. WHAT IS THE ANNUAL ENERGY EFFICIENCY IMPLEMENTATION PLAN REFERENCED IN THE SETTLEMENT AGREEMENT?**

A. The Settlement requires APS to file an annual implementation plan outlining the Company's proposed Energy Efficiency portfolio. The comprehensive Energy Efficiency Implementation Plan ("EEIP") will include, for the Commission's consideration, new programs and/or the expansion or enhancement of current programs necessary to achieve the energy targets for the following year. The EEIP must also contain the expected savings by program, as well as the range of proposed funding, by program, necessary to meet the energy savings targets. It also will include a proposed DSMAC rate to provide that funding, albeit on a partially lagged basis because the rate would not become effective until March 1st of the Plan year. The first such Implementation Plan (for 2010) will be filed on July 15th, 2009.

**Q. WHAT PROGRAM FEATURES IS THE 2010 IMPLEMENTATION PLAN REQUIRED TO INCLUDE?**

A. The Settlement directs APS to include the following in its initial EEIP:

a. A residential high performance new home program element with a second tier of performance and a higher customer financial incentive, which APS will file with the Commission on or before June 30, 2009;

b. A Home Performance program element within the Existing Home HVAC program. APS will design this program element with the goal of serving at least 1,000 existing homes by December 31, 2010;

c. A review of the APS low income weatherization program for possible enhancement;

d. A non-residential high performance new construction program element with a second tier of performance and a higher customer financial incentive;

e. A customer repayment/financing program element for schools, municipalities, and small businesses fully integrated in the non-residential programs; and

f. A goal for APS to serve, through its existing DSM programs or enhanced program elements, at least 100 schools by December 31, 2010.

**Q. WHY IS THE EEIP BEING FILED BEFORE THE APPROVAL OF THE SETTLEMENT?**

A. The Settlement requires aggressive levels of energy efficiency to be achieved in 2010. For those levels to be achieved, the EEIP must be approved concurrent with the Settlement so that the new program elements can be in place as early in 2010 as possible. The Settlement provides that Staff will review the Plan and:

> ...provide its recommendations to the Commission, in sufficient time so that the Commission may consider these matters at its regular November

> Open Meeting. In an effort to achieve timely approval of the Plan, the Signatories urge the Commission to take action on the Implementation Plan on or before the date it takes action on the Agreement. Such Implementation Plan will make clear that its obligations therein are contingent upon Commission approval of the Agreement. *See* Proposed Settlement Agreement dated June 12, 2009, page 30.

**Q. IN YOUR OPINION, SHOULD THE IMPLEMENTATION PLAN REPLACE CURRENT REPORTING REQUIREMENTS?**

A. Yes. The current reporting requirements will become redundant and unnecessary once the Implementation Plan is approved, as the Implementation Plan will encompass all of the information presented by the current reporting requirements, but will be combined into one filing. The current reporting requirements that will no longer be necessary include the 3-year portfolio plan filing, the semi-annual DSM reports, the annual conservation report, and the Demand Side Management Adjustment Charge recovery request.

## V. <u>NEW PROGRAMS AND MEASURES</u>

**Q. HOW DOES APS EXPECT TO MEET THESE GOALS FROM 2010 TO 2012?**

A. In order to meet these goals, APS will have to expand the existing portfolio of programs and introduce new EE programs and measures, as agreed to in the Settlement.

**Q. WHAT NEW PROGRAM ENHANCEMENTS WILL BE INTRODUCED WITH APPROVAL OF THE SETTLEMENT AND THE IMPLEMENTATION PLAN?**

A. APS will be proposing to introduce the following program enhancements in 2010: a residential high performance new construction program element, a home performance program element, additions to its current low income weatherization program, a non-residential high performance new construction program element, a customer repayment financing feature, and a specific target for the number of schools served. In addition to these elements, additional enhancements may be proposed in future years.

**Q. WILL YOU PLEASE DISCUSS THE SETTLEMENT'S PROVISION FOR RESIDENTIAL HIGH PERFORMANCE NEW CONSTRUCTION HOMES?**

A. The high performance new construction measure was filed with the Commission on June 29, 2009 in compliance with Decision No. 70666. The program represents a significant step towards the goal of "zero net energy" homes, requiring an energy efficiency improvement of at least 30% compared to a standard new construction home. This is twice the energy savings than the current ENERGY STAR construction measure. APS will combine the marketing of this program with renewable energy incentives for builders to encourage the development of energy efficient and solar communities that reduce energy use by 50% or more.

**Q. WHAT IS THE HOME PERFORMANCE PROGRAM ELEMENT REFERENCED IN THE SETTLEMENT?**

A. The Home Performance Program element will be a comprehensive on-site home energy efficiency assessment and retrofit program. It will be delivered by certified home performance contractors, who will use tools such as blower doors, duct blasters and infrared cameras to assess a home's energy efficiency. The program will bundle several cost-effective measures such as whole house air-sealing, duct sealing, attic insulation, shade screens, and direct installation of compact fluorescent light bulbs and low flow fixtures to offer a customized package of efficiency improvements that can attain significant savings per household. The program will be based on the national EPA/DOE Home

Performance with ENERGY STAR program framework which has been implemented successfully in several other states. By combining targeted marketing and consumer education with the brand awareness and successful program framework of the national ENERGY STAR program, APS has agreed to reach at least 1,000 existing households with this program by the end of 2010.

**Q. WILL YOU PLEASE DESCRIBE THE SETTLEMENT'S PROVISION REGARDING THE LOW INCOME WEATHERIZATION PROGRAM?**

A. The Settlement calls for a review of the low income weatherization program for possible enhancements. APS plans to conduct such a review and recommend possible enhancements for 2010 in the EEIP. Potential enhancements may include changing the income guideline for program qualification, expanding the measures included in the scope of weatherization activities, and providing funding for multi-family public housing facilities.

**Q. WILL YOU PLEASE DISCUSS THE SETTLEMENT'S PROVISION FOR THE NON-RESIDENTIAL HIGH PERFORMANCE NEW CONSTRUCTION PROGRAM ELEMENT?**

A. This proposed program element is designed to encourage developers to implement additional EE measures in newly constructed buildings. Incentives are designed to increase as the building exceeds baseline efficiency levels. This tiered approach will encourage and enable the adoption of higher efficiency technologies and practices in new buildings. The integrated whole-building design incentive will be paid based on the modeled amount of annual electricity savings compared to current building guidelines. Graduated incentives will increase as the whole building becomes more energy efficient. The program will also provide a Design Team incentive that will influence design professionals to include high efficiency systems and technologies in their whole building design.

**Q. WILL YOU PLEASE DESCRIBE THE NON-RESIDENTIAL CUSTOMER REPAYMENT FINANCING PROGRAM?**

A. The current Solutions for Business program will be expanded to offer a financing repayment option to schools, municipalities and small businesses to help them overcome the initial cost barriers to implementing energy efficiency. The repayment program will be fully integrated into the Solutions for Business program from the customer's perspective, so that participation will be easy for the customer. APS will manage the program and provide parallel billing to participating customers for ease of repaying the amount financed.

**Q. WHAT IS MEANT IN THE SETTLEMENT AGREEMENT BY THE TARGET TO SERVE AT LEAST 100 SCHOOLS?**

A. Under the Settlement, APS would serve at least 100 schools through the Solutions for Business program by the end of 2010. In order to meet this target, APS plans to:

- Develop a repayment program for energy efficiency projects, as mentioned above.
- Increase the school program customer cap from $25,000 to $100,000 per district, so larger projects can be funded.
- Work with the Arizona Schools Facilities Board on how the American Recovery and Reinvestment Act ("ARRA") funds for schools ($20 million) can be leveraged with utility rebates.

In addition to these program enhancements, APS will continue to:

- Market the recently approved direct install measures to schools. These measures are aimed primarily at lighting and refrigeration efficiency improvements. The Direct Install measures can pay up to 90% of project costs, making it attractive to many school districts.
- Provide tailored outreach to the Association of School Business Officials ("ASBO"), including targeted training classes and presentations to school districts.

**Q. WHAT OTHER PROGRAM MODIFICATIONS ARE CALLED FOR IN THE SETTLEMENT?**

A. The Settlement also proposes that large customers should be allowed to self-direct their DSM funds to energy efficiency projects.

**Q. WHAT IS SELF-DIRECTION?**

A. Self-direction is a term used to describe the ability of a customer or class of customers to reserve a portion of their individual contributions to a system-wide DSM fund for their exclusive use. Those reserved contributions would then be used to fund qualifying projects at the contributing customer's facilities.

**Q. HOW WILL THE SELF-DIRECTION PROGRAM OUTLINED IN THE SETTLEMENT WORK?**

A. The energy efficiency self-direction program as contemplated in the Settlement would work as follows:

- Customer's service accounts must total in excess of 40 million kWh during a 12-month period, collectively or individually, to be eligible to participate.

- Eligible customers must declare their desire to self-direct their funds prior to the beginning of the calendar year the contribution is made.
- Eligible customers must provide a project application to the Company for review and approval. APS will then verify that the technologies included in the application meet program guidelines and will review the energy efficiency savings claims for reasonableness.
- Funds will be reserved and disbursed annually following completion of the project, until the project is fully funded or the customer's contributions are exhausted.
- APS will be responsible for providing measurement and verification of energy or demand savings after the project is in operation. All kWh energy and kW demand savings will be claimed by APS to meet the Company's energy efficiency goals.

## VI. ESTIMATED COST OF ENERGY EFFICIENCY PROGRAMS IN 2010

**Q. WHAT DOES APS EXPECT THE COST OF THE ENERGY EFFICIENCY PROGRAMS TO BE IN 2010?**

A. As will be described in our 2010 EEIP filing on July 15, 2009, APS estimates the total cost to achieve the energy savings goal in 2010 to be in the range of $40 to $50 million.

**Q. HOW WILL THESE PROGRAM COSTS BE RECOVERED?**

A. The proposed funding amount will be collected through the DSMAC beginning in March of 2010.

**Q. DOES APS EXPECT THE COSTS TO INCREASE FOR 2011 AND 2012?**

A. Yes. Based on the need for additional programs in 2011 and 2012 to meet the increasingly aggressive energy savings targets, coupled with the market saturation of some energy efficiency measures, and higher energy efficiency baseline standards, APS expects that the program implementation costs will increase in those years.

**Q. WHY ARE THE COSTS OF IMPLEMENTING DSM EXPECTED TO RISE OVER TIME?**

A. APS is currently implementing the lowest cost programs and measures to achieve its current energy savings. With higher savings targets, additional programs and measures will need to be introduced into the portfolio that are still cost effective, but that have a higher cost per kWh saved than current programs. The combination of higher savings goals and higher costs per unit saved will drive the future cost of implementing energy efficiency programs higher each succeeding year.

## VII. <u>MORE CONCURRENT DSMAC</u>

**Q. HOW DOES THE PROPOSED DSMAC DIFFER FROM APS'S CURRENT MECHANISM?**

A. An important change in the Settlement's proposed DSMAC from the Company's current mechanism is the movement toward more timely recovery of DSM expenses. The proposed mechanism will allow the company to recover the estimated costs of meeting the energy savings goals closer to the same time those expenses are incurred by utilizing budgeted expenditures to calculate the mechanism change. Today, the adjustor is calculated using only historical expense information. APS witness David Rumolo, who is more familiar with the DSMAC Plan of Administration, will provide detailed mechanics of how the revised DSMAC will operate in practice.

**Q. DO OTHER ARIZONA UTILITIES HAVE SIMILAR COST RECOVERY OF DSM/EE COSTS?**

A. Yes. In fact, the Settlement's proposed DSMAC is similar to the Commission approved DSM adjustor for Tucson Electric Power Company (Decision No. 70628, December 1, 2008).

**Q. HOW DOES TEP'S DSM ADJUSTOR COMPARE TO THE PROPOSED DSMAC FOR APS?**

A. Like the TEP adjustor, program costs and performance incentives will begin to be recovered during the year they will be incurred based on estimated costs and then later trued-up to actual costs. Like TEP, APS will earn no interest or other return on under-recoveries but must credit its customers with interest on any over-recoveries. However, the Company's DSM program differs from TEP in that APS will file annually an Implementation Plan that provides detailed information for programs, program costs, and DSMAC rate impacts for Commission review and approval. Also, APS is providing a proposed Plan of Administration for Commission approval as part of this Settlement proceeding. As noted above, the Plan of Administration for the DSMAC is described in Mr. Rumolo's testimony.

**Q. WHY IS IT IMPORTANT TO HAVE MORE CONCURRENT RECOVERY?**

A. More current DSM cost recovery is desirable for all stakeholders. Matching the timing of expense with the recovery of those expenditures results in customers having a more accurate price signal than a lagging mechanism does. Also, the lag between the incurrence of cost and its recovery is minimized or eliminated, that is, when costs are recovered in the same period in which they are incurred, it promotes a more favorable cash flow and reduces the costs of financing a lagged recovery.

**Q. WILL THERE BE A TRUE-UP EACH YEAR OF ACTUAL EXPENDITURES VERSUS EXPECTED EXPENDITURES?**

A. Yes. The total amount of projected expense to be recovered through the DSMAC in any one year will be adjusted by any previous year under or over collection of expenses.

VIII. CONCLUSION

**Q. DO YOU HAVE ANY CONCLUDING REMARKS?**

A. Yes, APS is committed to the implementation of increased energy efficiency opportunities for its customers. This Settlement Agreement sets a new standard for DSM for the state of Arizona, which will enhance customer benefits for all Arizonans now and further in the future. The energy savings goals will help participating customers save an estimated $1.1 billion on their electric bills over the life of the measures installed in 2010 to 2012. The Settlement Agreement also begins to address the inherent financial challenges that result from enhanced energy efficiency programs. Finally, $CO_2$ emissions are expected to be reduced by nearly 6 million tons over the life of the measures installed in the next three years. APS believes that the combination of these customer bill savings and emission reductions bring benefits to APS customers and will advance Arizona's sustainable energy future.

**Q. DOES THIS CONCLUDE YOUR DIRECT SETTLEMENT TESTIMONY?**

A. Yes, it does.

**DIRECT SETTLEMENT TESTIMONY OF DAVID J. RUMOLO**

**On Behalf of Arizona Public Service Company**

**Docket No. E-01345A-08-0172**

July 1, 2009

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**DIRECT SETTLEMENT TESTIMONY OF DAVID J. RUMOLO ON BEHALF OF ARIZONA PUBLIC SERVICE COMPANY (Docket No. E-01345A-08-0172)**

I. INTRODUCTION

**Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

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

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

A. I am the Regulation and Pricing Manager.

**Q. ARE YOU THE SAME DAVID J. RUMOLO WHO FILED DIRECT TESTIMONY IN THIS DOCKET?**

A. Yes, I filed direct testimony in support of APS's application for rate relief.

**Q. WHAT IS THE PURPOSE OF YOUR SETTLEMENT TESTIMONY?**

A. My testimony supports and recommends that the Commission approve the Settlement Agreement ("Agreement"). I will address the rate design aspects of the Agreement and also discuss APS's proposed rate and service schedules as modified by the Agreement. The service schedules include Service Schedule 3 which is APS's line extension policy. I also discuss changes to plans of administration for the Demand Side Management Adjustment Charge and the Power Supply Adjustment charge.

II. SUMMARY

**Q. WOULD YOU PLEASE SUMMARIZE YOUR DIRECT SETTLEMENT TESTIMONY?**

A. Yes, my testimony describes the rate changes that implement the Agreement. The changes for residential customers include implementing what are generally "across the board" increases, i.e., the same percentage increase for each rate element of each rate schedule. Within the general service class, Rate Schedule E-32, there are changes that attempt to move the pricing so that it better tracks the results of the cost of service study prepared by APS in support of the rate case application. I also discuss revisions to APS's service schedules including Schedule 3, which is the APS Line Extension Policy. The revisions to Service Schedules 1, 4, 5, 8, 10, and 15 are the changes that had been proposed in the direct testimony of Mr. DeLizio and had no opposition from parties in the rate case. APS is proposing one change in Schedule 1 in addition to the changes proposed in the Direct Testimony of APS Witness Greg DeLizio. The additional change is to delete a provision regarding APS energy audits. This change will eliminate any potential confusion between that provision and energy assessments offered with Commission-authorized demand side management energy efficiency programs. APS is proposing additional modifications to Service Schedule 8, Bill Estimation, that updates bill estimation factors based on current data and adds language to address the methods of estimating bills for customers on new rate schedules that have been introduced since Schedule 8 was initially adopted.

The proposed revisions to Schedule 3 are all consistent with the Agreement and include modifications to the schedule language that eliminates the instruction to book Schedule 3 proceeds as Contributions in Aid of Construction ("CIAC"), clarifies what equipment is included in Local Facilities, adds language that allows refunds to a customer when an additional customer connects directly to an extension funded by the first customer, and adds provisions, including a

Statement of Charges, regarding the preparation of the estimates and billing statements for customers who will be funding extensions.

My testimony also discusses revisions to Plans of Administration for the Power Supply Adjustor ("PSA") and Demand Side Management Adjustor Charge ("DSMAC"). The revisions implement changes in accordance with provisions of the Agreement.

## III. RATE SCHEDULES

**Q. PLEASE DESCRIBE THE PROPOSED RATE CHANGES THAT ARE REFLECTED ON THE RATE SCHEDULES THAT HAVE BEEN FILED AS A RESULT OF THE SETTLEMENT.**

A. The proposed rate changes implement the concepts described in the Agreement. The changes include rate increases that generate $196.3 million in additional non-fuel base revenue plus additional base fuel revenues of $148.4 million for a total rate increase of $344.7 million. In general, the increased revenue is generated by raising rates in each rate schedule by an equal percentage. Worksheets that demonstrate customer bill impacts resulting from the Agreement are attached as Attachment DJR -1-S. The bill impacts shown on the Attachment reflect final rate designs and removal of the revenue adjustment for lost sales due to increased energy efficiency reflected in the Standard Filing Requirement Schedule H-2 filed by APS in its original application in this docket. The latter change was inadvertently overlooked previously and results in slightly lower percentage rate increases shown on the Attachment DJR-1-S compared to the bill impacts filed on May 15, 2009.

**Q. DO THE SETTLEMENT AGREEMENT RATE SCHEDULES INCLUDE ANY CHANGES TO RESIDENTIAL RATE SCHEDULES?**

A. Yes, as discussed in the Direct Testimony of APS Witness Greg Delizio, the design of Schedule E-12 was modified to include an additional inclining block rate component for high-use customers. This block was added in order to improve price signals to encourage energy conservation and also switching to time-of-use rate schedules. In addition, the Agreement rate schedules include freezing Rate Schedules ET-1 and ECT-1R to new customers as had been proposed by APS. The peak time period for Rate Schedules ET-1 and ECT-1R is 9:00 A.M. to 9:00 P.M on weekdays. In a previous rate case, APS introduced Rate Schedules ET-2 and ECT-2 in which the peak period is 12:00 noon until 7:00 P.M. In addition to being more "customer friendly", the peak periods in Rate Schedules ET-2 and ECT-2 better match the hours where APS's power supply costs are the highest. Therefore, Rate Schedules ET-2 and ECT-2 provides more appropriate price signals and are improved TOU rate designs compared to Rate Schedules ET-1 and ECT-1R.

**Q. ARE THERE ANY EXCEPTIONS TO THE CONCEPT OF EQUAL PERCENTAGE INCREASES FOR ALL RATES?**

A. Yes. Currently Rate Schedule E-32 covers all general service customers with loads under three thousand kilowatts ("kW"). Pursuant to a directive in Decision No. 69663 (June 28, 2007), this rate schedule will be broken into several discrete schedules based on load levels; customers with loads under 20 kW, customers with loads between 21 and 100 kW, 101- 400 kW, and over 400 kW up to 3,000 kW. This is being done so that rates can be designed to better track cost of service. For example, customers below 20 kW will receive an increase that is slightly higher than the Schedule E-32 group average while the rate for customers between 101 kW and 400 kW was designed to generate the group average increase.

For the largest general service customers, E-32 customers over 400 kW and customers on the industrial schedules E-34 and E-35 the increases are spread evenly between demand and energy charges after the basic service charges are adjusted.

**Q. UNDER THE TERMS OF THE SETTLEMENT AGREEMENT, IS APS OFFERING ANY NEW RATE SCHEDULES?**

A. Yes. A new super-peak rate schedule will be offered to residential customers. During the "super-peak" periods, customers who participated in the rate schedule will pay higher charges but will pay lower charges during other peak and off-peak periods. The "super-peak" period is defined as 3:00 P.M. to 6:00 P.M., Monday thru Friday during June, July, and August. These periods generally are the times when APS's marginal generation resources are the most expensive.

For residential and general service customers, APS will offer a critical peak pricing plan. The critical peak pricing ("CPP") plan is based on a design concept that is different than the super-peak rate concept in that the peak pricing periods are not pre-determined. Under the critical peak pricing plan, APS notifies customers of a CPP Event when the Company expects resources to be constrained. CPP Events can be triggered by severe weather, high loads, high wholesale resource prices or major generation or transmission outages. Customers will be notified, generally by 4:00 P.M. of the day prior to the CPP Event. General Service customers must be able to provide load reductions of at least 200 kW to participate in the CPP pilot. Customers will pay a higher price for energy during the CPP Events compared to other applicable general service rate schedules in exchange for lower prices during non-critical time periods.

The rate pilot will be made available to at least 200 general service customers and 300 residential customers.

The development of the residential super-peak pricing and general service critical peak pricing rate options was presented in the Direct Testimony of APS Witness Charles Miessner in this docket.

**Q. ARE THERE ANY OTHER NEW RATE OFFERINGS?**

A. Yes. If the Settlement Agreement is approved, APS will develop two new rate offerings. First, we will develop a new TOU rate that will be applicable to schools. The rate schedule will be designed to encourage schools to shift consumption to times of the day and months in which schools will contribute less to APS's system peak. Today, the school year in many districts starts during the month of August in many instances which is still during the heart of the peak summer cooling season and many schools schedule activities well into the late afternoon - also during the times of the daily peak. The new rate will provide price signals that might encourage some schools to modify schedules in order to lower energy bills. The proposed rate will be filed for approval within 90 days of Commission approval of the Agreement.

APS, working with other stakeholders, will also develop and offer an interruptible rate schedule and demand response programs to industrial customers. It is anticipated that the schedule or program will offer both short-term and long-term options that will provide benefits to APS and customers through load curtailment during certain peak periods. These programs/rate schedules will be filed for approval within 180 days of Commission approval of the Agreement.

## IV. LOW INCOME PROGRAMS

**Q. DOES THE AGREEMENT ADDRESS CHANGES TO THE DISCOUNT PROGRAM FOR LOW INCOME CUSTOMERS?**

A. Yes, in several ways. First, customers who are on or can qualify under the current low income rate schedules, Schedules E-3 and E-4 are "held harmless" from the rate increase. This required that APS develop a new series of rate schedules based on each of our existing residential rate schedules to reflect the "hold harmless" charges. Present Schedules E-3 and E-4 which simply modify existing residential rate schedules will continue to be applicable to low-income customers. For example, a customer on Schedule E-12 Low Income will also receive the Schedule E-3 discount or E-4 discount. Second, for customers whose income is greater than 150% of the federal poverty income level but whose income level is at or below 200% of the federal poverty level, APS's existing bill assistance program will be augmented. A one-time funding addition of $5 million from APS will be made available for the bill assistance program until such time as these funds are exhausted. Third, APS will waive additional security deposits for low-income customers in the following specific cases; 1) the customer has had more than two late payments in the previous 12 months, or 2) the customer has been disconnected for non-payment.

## V. RATE SCHEDULE E-20 APPLICABLE TO HOUSES OF WORSHIP

**Q. PLEASE DESCRIBE THE SETTLEMENT AGREEMENT TREATMENT OF RATE SCHEDULE E-20.**

A. In APS's last general rate increase, Rate Schedule E-20 was frozen by Decision No. 69663. Rate Schedule E-20 is restricted to specific applications for houses of worship. Existing customers were allowed to continue to be on the rate schedule but no new customers could be added. The rate was frozen by the

Commission to new customers because it did not generate sufficient revenue to pay anything close to cost of service. Moreover, the introduction of new general service time of rate schedules provided new opportunities for customers who can manage the time of their energy usage to save compared to non-TOU rate options. Schedule E-20 is also challenging from an administrative perspective since many religious facilities have become multi-purpose facilities. However, in recognition of the current challenging economic times, the Agreement allows Schedule E-20 to be re-opened to qualifying customers for a one-year period starting January 1, 2010.

## VI. SERVICE SCHEDULES

**Q. PLEASE DESCRIBE SERVICE SCHEDULE CHANGES THAT WILL BE IMPLEMENTED UPON APPROVAL BY THE COMMISSION IN THIS DOCKET.**

A. APS Witness Greg DeLizio proposed changes to Service Schedules 1, 4, 5, 8, 10, and 15 in his Direct Testimony filed in this docket. The changes included clarifications to existing language and brought the schedules better in line with business practices. These changes were not opposed by any party who filed testimony in the case and have been included in the Settlement Agreement Service Schedules that were filed on June 29, 2009.

**Q. DO THE REVISED SERVICE SCHEDULES INCLUDE ANY CHANGES IN ADDITION TO THOSE INCLUDED IN MR. DELIZIO'S TESTIMONY?**

A. Yes, we have proposed additional changes in Service Schedules 1 and 8. In Service Schedule 1, we are proposing that paragraph 4.6, which discusses on-site energy usage evaluations, be eliminated. In an earlier revision to Schedule 1, a charge of $82 for on-site energy evaluations was established. Generally, these evaluations were performed after receipt of a high-bill complaint from a customer. Because of the charge, APS has seen few requests for such on-site visits from customers. In 2008, the Company performed only four such visits. Today, APS provides customers an on-line tool to help them perform a self evaluation. For customers who do not have internet access or who want personal assistance, customer service representatives provide assistance to customers to help them evaluate energy usage. Should a customer desire an on-site visit in evaluating energy consumption, APS's energy efficiency programs provide assistance for a fee. Therefore, customers have several options for seeking energy efficiency assistance and it is recommended by the Company that paragraph 4.6 be eliminated. Elimination of paragraph 4.6 also reduces the potential confusion of that specific language with APS energy efficiency programs.

**Q. PLEASE DESCRIBE THE ADDITIONAL CHANGES RECOMMENDED FOR SERVICE SCHEDULE 8.**

A. Service Schedule 8 describes the methods that are used to estimated energy consumption or demand for billing purposes when a meter reading can not be obtained. Service Schedule 8 was adopted in Decision No. 69569 (May 21, 2007). The proposed changes accomplish several purposes. First, Decision No. 69569 requires that certain bill estimation factors such as average daily energy consumption for specified rate schedules, be reviewed and modified as more recent load research data becomes available. The tables found in Section 3 of Schedule 8 have been modified to reflect the most recent calendar year load research data. Estimation data for new rate schedules have also been included. Schedule 8 has also been modified to include bill estimation methods for new rate schedules that have been adopted since Decision No. 69569.

VII. SERVICE SCHEDULE 3

**Q. PLEASE DESCRIBE THE CHANGES TO SERVICE SCHEDULE 3 THAT ARE PROPOSED IN THE SETTLEMENT AGREEMENT.**

A. The Agreement includes several changes that are described in Section 10 of the Agreement. First, in order to improve APS's financial condition while attempting to moderate rate increases to customers, the Settlement Agreement proposes that proceeds received through Schedule 3 activities be recorded as revenue. Today, Schedule 3 proceeds are booked as CIAC. Second, APS is withdrawing its proposals for an Impact Fee and for collection of a System Facilities Charge as proposed in the original rate case application. Next, the schedule language is modified to clarify the description of the facilities that are included in the charges that applicants for extensions will pay. Fourth, Schedule 3 includes a Statement of Charges that lists billing elements that will be used to develop the details of the estimates and invoices that customers will receive. For example, the Statement of Charges contains a per foot charge for overhead line extension and the costs for transformers. The Statement of Charges will be used for most extensions. However and consistent with the line extension provisions approved in Tucson Electric Company's ("TEP") last rate case, project-specific extension cost estimates will continue to be developed for industrial customers and other "non-standard" projects such as relocations of existing facilities. Customers will be provided with sufficient detailed information so they can verify that they have been charged in accordance with the provisions of Schedule 3. Finally, the revised Schedule 3 includes a refund provision for individual single family residential line extensions. In Decision No. 69663, the Commission ordered APS to remove refund provisions in the line extension policy. However, the Agreement signatories believe that in certain specific instances, customers should be entitled to refunds. Specifically, if a permanent residential customer pays for an extension and in the future that extension is used directly to serve another customer, the first customer will be entitled to a refund based on a shared use of the extension and payment of extension costs by the subsequent customer.

**Q. THERE HAVE BEEN SEVERAL LETTERS TO THE DOCKET FROM MEMEBERS OF THE COMMISSION AND COMMENTS FROM CUSTOMERS REGARDING REESTABLISHMENT OF A FREE FOOTAGE ALLOWANCE OR EQUIPMENT ALLOWANCE. HAS THAT BEEN CONSIDERED BY THE SETTLMENT AGREEMENT SIGNATORIES?**

A. Yes, it has been the topic of significant discussion during the settlement process. One of the key elements of the settlement is that APS's financial condition had to be improved. This element is discussed at length in the testimony of APS Witness Jim Hatfield and in the testimony of APS Witness Jeff Guldner. As discussed earlier in my testimony, booking Schedule 3 proceeds as revenue is a critical element for the financial health of APS while also moderating rate impacts to existing customers. Projected levels of Schedule 3 proceeds, booked as revenue, have been included in the financial forecasts that were used by APS in the analyses that led to the conclusion that the Agreement is beneficial to the Company and its customers.

**Q. WHAT WOULD BE THE IMPACT ON THE EXPECTED FINANCIAL RESULTS IF THE COMMISSION ELECTED TO RE-ESTABLISH A FREE FOOTAGE BASIS OR EQUIPMENT ALLOWANCE BASIS DURING DELIBERATIONS ON THE SETTLEMENT AGREEMENT?**

A. To maintain the objectives of the Settlement, any changes to the terms of Schedule 3 would have to be revenue neutral. In other words, if the Commission elected to establish a policy that reduced the forecast Schedule 3 revenues by $5,000,000 per year, revenue increases would need to come from some other source. In order to provide context for the customer impact of such a change, APS estimated that $5 million dollars of reduced Schedule 3 proceeds requires an additional rate increase of approximately 0.2%. For an average residential customer, that equates to approximately $0.20 per month.

**Q. WERE YOU RESPONSIBLE FOR COMPUTING THE SCHEDULE 3 REVENUE IMPACTS THAT WERE INCLUDED IN APS'S RESPONSE TO THE JUNE 9, 2009 LETTER FROM CHAIRMAN MAYES AND PRIOR LETTERS FROM OTHER COMMISSIONERS?**

A. Yes, I was. I reviewed the line extension activity for individual single family residential line extensions over the past four years and used that information along with current customer growth forecasts to estimate the impacts on Schedule 3 revenue under the postulated scenarios. The revenue impacts, as provided in the response to the June 9, 2009 letter are attached as Attachment DJR-2-S.

## VIII. <u>PLANS OF ADMINISTRATION</u>

**Q. ARE YOU SPONSORING MODIFICATIONS TO PLANS OF ADMINISTRATION?**

A. Yes. On June 29, 2009, APS filed revised Plans of Administration for the Power Supply Adjustor ("PSA") and the Demand Side Management Adjustment Charge ("DSMAC"). The revised plans are based on changes that are components of the Settlement Agreement.

**Q. PLEASE DESCIBE THE CHANGES TO THE PSA PLAN.**

A. Section 6.3 of the Settlement Agreement requires that gains on the sale of SO2 allowances over or under a base amount of $7.045 million would be recovered or refunded through the PSA. The changes to the PSA Plan of Administration implements that requirement. The Plan of Administration language has also been updated to eliminate language that simply described previous plan changes and which is no longer needed.

**Q. PLEASE DESCRIBE THE CHANGES TO THE DSMAC PLAN OF ADMINISTRATION.**

A. The DSMAC will be modified to allow for more current recovery of program costs. The revised DSMAC is similar to the DSMAC that the Commission recently approved for TEP in Decision No. 70628 and the Plan of Administration implements the revised DSMAC method.

**Q. CAN YOU PROVIDE A BRIEF SUMMARY THAT DESCRIBES HOW THE REVISED DSMAC WILL OPERATE AS SHOWN IN THE PLAN OF ADMINISTRATION?**

A. Yes I can. The DSMAC is designed to recover program costs, including energy efficiency programs, demand response programs, and energy efficiency program performance incentives. The charges developed through the DSMAC calculations are applied to residential customers as a per kWh energy charge and to general service customers on either a per kWh charge or per kW demand charge depending on whether the customer's base rate is computed with a demand charge element.

Each year, the APS Energy Efficiency Implementation Plan ('Plan") including the DSMAC will be filed with the Commission for approval. As part of the Plan filing, APS will include the computations for the DSMAC that will become effective in March of the subsequent year and the revised DSMAC rate schedule. The DSMAC calculations will include the spending levels required in accordance with the Plan and corresponding incentives, a forecast of energy sales for the subsequent year, and computation of any required true-ups. A true-up mechanism is required because the DSMAC will be based on projections of costs, incentives and sales and the true-up calculations will account for variations between forecasts and actual data. The DSMAC calculations also apply an interest factor in years in which overcollections occur. There is no interest computed if undercollections occur. Thus, the DSMAC is asymmetrical to the benefit of APS customers.

## IX. CONCLUSION

**Q. DO YOU HAVE ANY CONCLUDING REMARKS?**

A. My testimony discusses topics regarding the implementation of the Agreement. I discuss changes to rate schedules, service schedules and plans of administration. I believe that the Agreement provides important benefits to customers such as introduction of new pricing structures and provides for additional revenue that is critical to the long term financial health of the Company. I recommend the Commission approve the Agreement.

**Q. DOES THIS CONCLUDE YOUR DIRECT SETTLEMENT TESTIMONY?**

A. Yes.

Monthly Bill
Rate Case Settlement Proposal
June 30, 2009

**ARIZONA PUBLIC SERVICE COMPANY**
**Preliminary Estimated Monthly Bill Impacts of Proposed Settlement Rates 6/30/09**

| Residential (Average - All Rates) | Current Rates<br>Annual Average Monthly Bill (1) | Proposed Rates<br>Annual Average Monthly Bill (2) | | Current Rates<br>Summer Monthly Bill | Proposed Rates<br>Summer Monthly Bill | Current Rates<br>Winter Monthly Bill | Proposed Rates<br>Winter Monthly Bill |
|---|---|---|---|---|---|---|---|
| Average kWh per Month | 1,177 | 1,177 | | 1,417 | 1,417 | 936 | 936 |
| Base Rates | $ 116.78 | $ 131.66 | | $ 151.17 | $ 170.44 | $ 82.38 | $ 92.88 |
| PSA- Forward Component | 5.98 | - | | 7.20 | - | 4.75 | - |
| PSA - Historical Component | 0.31 | 0.31 | | 0.37 | 0.37 | 0.24 | 0.24 |
| Interim Rate Adjustor (January 2009) | 2.66 | - | | 3.20 | - | 2.12 | - |
| TCA (July 1, 2008) | 1.42 | 1.42 | | 1.71 | 1.71 | 1.13 | 1.13 |
| CRCC (April 2005) | 0.40 | 0.40 | | 0.48 | 0.48 | 0.32 | 0.32 |
| EIS (July 2007) | 0.19 | 0.19 | | 0.23 | 0.23 | 0.15 | 0.15 |
| RES (Jan 1, 2009) | 3.17 | 3.17 | | 3.17 | 3.17 | 3.17 | 3.17 |
| DSMAC (April 2009) | 0.72 | 0.72 | | 0.86 | 0.86 | 0.57 | 0.57 |
| Total | $ 131.63 | $ 137.87 | | $ 168.39 | $ 177.26 | $ 94.83 | $ 98.46 |
| Bill Impact (3) | | $ 6.24 | | | $ 8.87 | | $ 3.63 |
| Percent Bill Impact | | 4.74% | | | | | |
| | | | | | | | |
| Reduction from accelerated reset of PSA Historical Component | | TBD | TBD | | TBD | | TBD |
| Increase from Projected 2010 DSMAC (low income exempt) | | $ 0.53 | 0.40% | | $ 0.64 | | $ 0.42 |
| Increase from Projected 2010 RES (4) | | $ 0.86 | 0.65% | | $ 0.86 | | $ 0.86 |

| Residential (Rate E-12) | Annual Average Monthly Bill (1) | Annual Average Monthly Bill (2) | | Summer Monthly Bill | Summer Monthly Bill | Winter Monthly Bill | Winter Monthly Bill |
|---|---|---|---|---|---|---|---|
| Average kWh per Month | 763 | 763 | | 880 | 880 | 645 | 645 |
| Base Rates | $ 81.71 | $ 92.19 | | $ 102.11 | 115.21 | $ 61.30 | 69.16 |
| PSA- Forward Component | 3.88 | - | | 4.47 | - | 3.28 | - |
| PSA - Historical Component | 0.20 | 0.20 | | 0.23 | 0.23 | 0.17 | 0.17 |
| Interim Rate Adjustor (January 2009) | 1.73 | - | | 1.99 | - | 1.46 | - |
| TCA (July 1, 2008) | 0.92 | 0.92 | | 1.06 | 1.06 | 0.78 | 0.78 |
| CRCC (April 2005) | 0.26 | 0.26 | | 0.30 | 0.30 | 0.22 | 0.22 |
| EIS (July 2007) | 0.12 | 0.12 | | 0.14 | 0.14 | 0.10 | 0.10 |
| RES (Jan 1, 2009) | 3.17 | 3.17 | | 3.17 | 3.17 | 3.17 | 3.17 |
| DSMAC (April 2009) | 0.46 | 0.46 | | 0.53 | 0.53 | 0.39 | 0.39 |
| Total | $ 92.45 | $ 97.32 | | $ 114.00 | $ 120.64 | $ 70.87 | $ 73.99 |
| Bill Impact (3) | | $ 4.87 | | | $ 6.64 | | $ 3.12 |
| Percent Bill Impact | | 5.27% | | | | | |
| | | | | | | | |
| Reduction from accelerated reset of PSA Historical Component | | TBD | TBD | | TBD | | TBD |
| Increase from Projected 2010 DSMAC (low income exempt) | | $ 0.35 | 0.38% | | $ 0.40 | | $ 0.29 |
| Increase from Projected 2010 RES (4) | | $ 0.86 | 0.93% | | $ 0.86 | | $ 0.86 |

**ARIZONA PUBLIC SERVICE COMPANY**
**Preliminary Estimated Monthly Bill Impacts of Proposed Settlement Rates 6/30/09**

| Commercial (Rate E-32) | Current Rates Annual Average Monthly Bill (1) | Proposed Rates Annual Average Monthly Bill (2) | | Current Rates Summer Monthly Bill | Proposed Rates Summer Monthly Bill | Current Rates Winter Monthly Bill | Proposed Rates Winter Monthly Bill |
|---|---|---|---|---|---|---|---|
| Average kWh per Month | 8,769 | 8,769 | | 9,746 | 9,746 | 7,792 | 7,792 |
| Base Rates | $ 781.15 | $ 884.44 | | $ 921.60 | $ 1,043.47 | $ 640.69 | $ 725.41 |
| PSA- Forward Component | 44.55 | - | | 49.51 | - | 39.58 | - |
| PSA - Historical Component | 2.26 | 2.26 | | 2.51 | 2.51 | 2.01 | 2.01 |
| Interim Rate Adjustor (January 2009) | 19.82 | - | | 22.03 | - | 17.61 | - |
| TCA (July 1, 2008) | 15.22 | 15.22 | | 16.91 | 16.91 | 13.53 | 13.53 |
| CRCC (April 2005) | 2.96 | 2.96 | | 3.29 | 3.29 | 2.63 | 2.63 |
| EIS (July 2007) | 1.41 | 1.41 | | 1.56 | 1.56 | 1.25 | 1.25 |
| RES (Jan 1, 2009) | 69.60 | 69.60 | | 77.35 | 77.35 | 61.85 | 61.85 |
| DSMAC (April 2009) | 6.52 | 6.52 | | 7.24 | 7.24 | 5.79 | 5.79 |
| Total | $ 943.49 | $ 982.41 | | $ 1,102.00 | $ 1,152.33 | $ 784.94 | $ 812.47 |
| Bill Impact (3) | | $ 38.92 | | | $ 50.33 | | $ 27.53 |
| Percent Bill Impact | | 4.13% | | | | | |
| | | | | | | | |
| Reduction from accelerated reset of PSA Historical Component | | TBD | TBD | | TBD | | TBD |
| Impact from Projected 2010 DSMAC | | $ 3.95 | 0.42% | | $ 4.39 | | $ 3.51 |
| Impact from Projected 2010 RES | | $ 18.85 | 2.00% | | 20.95 | | 16.75 |

| Industrial (Rate E34/35 Medium Load Factor) | Annual Average Monthly Bill (1) | Annual Average Monthly Bill (2) | | Summer Monthly Bill | Summer Monthly Bill | Winter Monthly Bill | Winter Monthly Bill |
|---|---|---|---|---|---|---|---|
| Average kWh per Month | 2,250,284 | 2,250,284 | | 2,344,877 | 2,344,877 | 2,155,690 | 2,155,690 |
| Base Rates | $ 201,730.50 | $ 228,929.00 | | $ 210,209.00 | $ 238,550.00 | $ 193,252.00 | $ 219,308.00 |
| PSA- Forward Component | 11,431.45 | - | | 11,911.98 | - | 10,950.91 | - |
| PSA - Historical Component | 580.58 | 580.58 | | 604.98 | 604.98 | 556.17 | 556.17 |
| Interim Rate Adjustor (January 2009) | 5,085.64 | - | | 5,299.42 | - | 4,871.86 | - |
| TCA (July 1, 2008) | 2,666.44 | 2,666.44 | | 2,778.52 | 2,778.52 | 2,554.35 | 2,554.35 |
| CRCC (April 2005) | 760.60 | 760.60 | | 792.57 | 792.57 | 728.62 | 728.62 |
| EIS (July 2007) | 360.05 | 360.05 | | 375.18 | 375.18 | 344.91 | 344.91 |
| RES (Jan 1, 2009) | 353.78 | 353.78 | | 353.78 | 353.78 | 353.78 | 353.78 |
| DSMAC (April 2009) | 2,106.39 | 2,106.39 | | 2,194.93 | 2,194.93 | 2,017.84 | 2,017.84 |
| Total | $ 225,075.43 | $ 235,756.84 | | $ 234,520.36 | $ 245,649.96 | $ 215,630.44 | $ 225,863.67 |
| Bill Impact (3) | | $ 10,681.41 | | | $ 11,129.60 | | $ 10,233.23 |
| Percent Bill Impact | | 4.75% | | | | | |
| | | | | | | | |
| Reduction from accelerated reset of PSA Historical Component | | TBD | TBD | | TBD | | TBD |
| Impact from Projected 2010 DSMAC | | $ 1,566.74 | 0.70% | | $ 1,632.60 | | $ 1,500.88 |
| Impact from Projected 2010 RES | | $ 95.83 | 0.04% | | 95.83 | | 95.83 |

Notes:
(1) Bill excludes regulatory assessment charge, taxes and fees. Adjustor levels and interim base rate surcharge in effect as of May 1, 2009.
(2) Bill impacts reflect the proposed increase in base rates, reset of interim adjustor to zero, and reset of PSA Forward Component charge to zero.
(3) Bill impacts for commercial and industrial customers are less than residential on a percentage basis because these customer classes were assessed proportionally more for the interim adjustor and the PSA. The base rates reflect approximately the same percentage increase as residential.
(4) RES impacts are based on a preliminary estimate. Actual bill impacts will be filed with the 2010 implementation plan to be filed in July 2009. Of the projected increase in the RES budget for 2010, only about $1 to $2 million is attributable to the settlement.

## Increase Over Base Rates for Representative Customers

| | Beginning Base Rate Revenue Increase | Impact of E-3, E-4 Hold Harmless Rate Design | Increase in Base Rates After E-3, E-4 Rate Design (A) + (B) + (C) | Fuel Related Increase (A) | Non-Fuel Related Increase (B) | Increase Related To Interim (C) |
|---|---|---|---|---|---|---|
| Residential (All Rates) | 12.99% | -0.25% | 12.74% | 5.12% | 5.34% | 2.28% |
| Residential (Rate E-12) | 12.99% | -0.16% | 12.83% | 4.75% | 5.96% | 2.12% |
| Commercial (Rate E-32) | 12.99% | 0.23% | 13.22% | 5.70% | 4.98% | 2.54% |
| Industrial (Medium Load Factor) | 12.99% | 0.49% | 13.48% | 5.67% | 5.29% | 2.52% |

Monthly Bill
Rate Case Settlement Proposal
June 30, 2009

**INPUT TO BILL COMPS**
Proposed Increase - GRC Settlement Proposal

| | Increase ($000) | % |
|---|---|---|
| Base Rate | 196,300 | 7.40% |
| Fuel - base rates | 11,203 | 0.42% |
| Total base rate increase | 207,503 | 7.82% |
| Adjusted base cost of fuel increase | 137,235 | 5.17% |
| Total base rate increase | 344,738 | 12.99% |
| Adjusted Present Revenue - base rates ($000) | 2,654,236 | without DSM proforma |
| Adjusted TY MWh | 29,075,819 | without DSM proforma |
| TY E-3, E-4 MWh | 460,909 | |
| net | 28,614,910 | |

| | | | |
|---|---|---|---|
| Revenue Requirement E-3, E-4 hold harmless | $ | 6,000,000 | |
| rev requirement $/kwh | $ | 0.0002097 | |
| Residential TY adjusted kWh | | 13,556,815,396 | |
| TY E-3, E-4 MWh | | 460,909,000 | |
| net | | 13,095,906,396 | |
| residential benefit $/kWh | $ | 0.0004582 | |
| | | (0.0002485) | net residential impact $/kwh |
| | | (0.0002468) | check from class average assessment |

# ESTIMATED IMPACTS TO SETTLEMENT REVENUE LEVELS OF DIFFERING SCHEDULE 3 SCENARIOS FOR SINGLE RESIDENTIAL CUSTOMER LINE EXTENSIONS

| | 2010 | 2011 | 2012 |
|---|---|---|---|
| Settlement with the modifications to Schedule 3 referenced therein. | $ 0 | $ 0 | $ 0 |
| Scenario 1 – 1,000 ft free if under $25,000. Full amount paid if over $25,000.[1] | $5,960,000 | $6,850,000 | $10,000,000 |
| Scenario 2 – Free footage if under $5,000/$10,000 (as applicable). Full amount paid if over $5,000/$10,000 (as applicable). | | | |
| 50 ft. – up to $5,000 | $ 580,000 | $ 660,000 | $ 960,000 |
| 100 ft. – up to $5,000 | $ 600,000 | $ 680,000 | $ 990,000 |
| 500 ft. – up to $10,000 | $ 2,760,000 | $3,140,000 | $ 4,550,000 |
| 750 ft. – up to $10,000 | $ 2,800,000 | $3,190,000 | $ 4,600,000 |
| Scenario 3 – Free footage approach subject to an investment cap. | | | |
| 50 ft. but not more than $5,000 | $ 2,600,000 | $2,960,000 | $ 4,280,000 |
| 100 ft. but not more than $5,000 | $ 2,640,000 | $3,000,000 | $ 4,330,000 |
| 500 ft. but not more than $10,000 | $ 4,815,000 | $5,460,000 | $ 7,850,000 |
| 750 ft. but not more than $10,000 | $ 5,125,000 | $5,800,000 | $ 8,300,000 |
| Scenario 4 - $5,000 equipment allowance. | $ 3,470,000 | $3,860,000 | $ 5,450,000 |

[1] This is the same line extension policy in existence prior to July 2007. Once an individual applicant's project exceeded $25,000 in estimated costs, it was no longer eligible for any free footage allowance regardless of the length of the extension.