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BEFORE THE ARIZONA CORPORATION

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COMMISSIONERS

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

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

INITIAL POST-HEARING BRIEF
 OF
 ARIZONA PUBLIC SERVICE COMPANY

October 9, 2009

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1 I. INTRODUCTION

2 *"The settlement provides a road map . . . that will move the company toward*
3 *financial health, and in return provide ratepayers with rate stability and comfort*
4 *in knowing that there's a comprehensive plan in place to secure Arizona's*
5 *energy future."*

6 - Opening Statement of Daniel Pozefsky on behalf of the Residential
7 Utility Consumer Office ("RUCO"), Tr. at 173.

8 The Proposed Settlement Agreement ("Agreement") presented to the Arizona
9 Corporation Commission ("Commission") for approval is arguably the most comprehensive
10 and broadly-supported rate settlement in the Commission's history. The Agreement is
11 supported by 22 of the 24 parties to the underlying rate case – parties representing a
12 universal range of interests, including the Commission's own Staff, RUCO on behalf of
13 residential customers, and Freeport-MacMoRan Copper & Gold Inc. (f.k.a. Phelps Dodge
14 Corporation), Arizonans for Electric Choice and Competition ("AECC")¹, Kroger Co.,
15 Catalyst Paper, and SCA Tissue on behalf of Arizona Public Service Company's ("APS" or
16 "Company") commercial and industrial customers. The Agreement has been signed by
17 representatives of merchant generators, public schools, agricultural interests, and federal
18 agencies, including two of Arizona's largest military bases. It is also supported by
19 representatives of limited-income customers, union workers, and energy efficiency and
20 renewable energy advocates. As the Editorial Board of the Arizona Republic put it, "when
21 environmentalists, consumer advocates, mining operations, and school officials find
22 common ground, it's as rare and remarkable as snow flurries in Phoenix." Editorial,
23 *Unusual Unity on Rate Increase Good for State*, ARIZONA REPUBLIC, August 30, 2009.

24 Each of these various parties ("Settling Parties") determined after many months of
25 extensive, detailed, and often-times contentious negotiations that the package provided by
26 the Agreement serves their individual interests and, more importantly, the public interest.
27 See Hearing Testimony of RUCO Witness Dr. Ben Johnson ("Dr. Johnson Testimony"), Tr.
28 at 1960-1961; Hearing Testimony of Staff Witness Ralph Smith ("Smith Testimony"), Tr.

¹ AECC is a coalition of a broad range of commercial and industrial interests.

1 at 1716; Hearing Testimony of Staff Witness Elijah Abinah (“Abinah Testimony”), Tr. at
2 1801, 1833 and 1837; Hearing Testimony of Arizona Investment Council (“AIC”) Witness
3 Gary Yaquinto (“Yaquinto Testimony”), Tr. at 2274; Hearing Testimony of RUCO Witness
4 Jodi Jerich (“Jerich Testimony”), Tr. at 2316 - 2317; Hearing Testimony of APS Witness
5 James Hatfield (“Hatfield Testimony”), Tr. at 2471. The only party to express any
6 dissatisfaction with the Agreement, Barbara Wyllie-Pecora, objects to just one specific
7 aspect of its many interwoven components – the continuation of the current Commission
8 policy requiring individual residential applicants for a line extension to pay the cost of that
9 service, rather than subsidizing that cost through base rates. And even here, the Agreement
10 proposes several significant modifications to APS’s line extension policy that address many
11 of the concerns raised about it. *See* Agreement at § 10.7.

12 As to its substance, the Agreement itself does much more than simply resolve a rate
13 case. More broadly, it initiates a sustainable course toward Arizona’s energy future – a
14 future of less frequent and more predictable rate cases, of higher levels of energy efficiency
15 and renewable energy, of heightened protections for the Company’s most vulnerable
16 customers, of more transparent accountability and of greater financial stability for APS –
17 and it specifically charts the first five years in the direction of that goal. The Agreement
18 accomplishes all of this while impacting customer bills to only a minimal degree during
19 what all acknowledge are uniquely difficult economic times. **Indeed, the package**
20 **proposed would result in a net annual increase to bills of less than 1% to the average**
21 **residential customer** – a far more modest increase than others recently approved by public
22 utility commissions throughout the nation to utilities of far better financial health than APS,
23 notwithstanding this economic recession. *See* Dr. Johnson Testimony, Tr. at 1920; Hearing
24 Testimony of AECC Witness Kevin Higgins (“Higgins Testimony”), Tr. at 304; Hearing
25 Testimony of APS Witness Jeff Guldner (“Guldner Testimony”), Tr. at 1023.

26 The Agreement’s economic package contains several creative means to sustain
27 APS’s financial condition for more than the next two-and-a-half years without adding to the
28 base rate increase proposed by the Agreement. As every witness who testified on this issue

1 made clear, these accounting measures – including the revenue treatment of APS line
2 extension proceeds, the deferral of a portion of the Company’s increasing pension and
3 OPEB costs, and an adjustment to the depreciation rates applied to the Palo Verde Nuclear
4 Generating Station (“Palo Verde”) (reflecting a potential license extension) – were nothing
5 short of essential to reaching an agreement on the base rate increase in this case and are well
6 within the Commission’s power to adopt. The Settling Parties specifically included these
7 mechanisms to moderate and stabilize the base rate increase for customers until at least
8 mid-2012, while also keeping APS’s financial health at endurable levels during the required
9 stay-out, thus allowing APS to fulfill the many other commitments it has made in the
10 Agreement.

11 In short, the proposed Agreement is the result of many months of give and take by its
12 22 diverse supporters. It creatively and comprehensively resolves a complex dispute in a
13 manner that produces tremendous future benefits for APS customers and the State of
14 Arizona. Among other things described well in Section 1.16 of the Agreement, it:

- 15 • Provides rate stability for customers and other interested stakeholders;
- 16 • Increases the transparency of APS’s accountability;
- 17 • Requires a permanent reduction to APS’s cost structure of \$150 million from
18 January 1, 2010 until year-end 2014;
- 19 • Sets ambitious energy efficiency measures, adopting the first ever energy
20 efficiency standard for any Arizona utility;
- 21 • Requires large-scale investments in renewable resources, obligating APS to
22 double the requirement of the Commission’s Renewable Energy Standard
23 (“RES”) and obtain approximately 10% of its resources from renewable
24 energy by 2015;
- 25 • Protects the limited-income members of our community, APS’s most
26 vulnerable customers;
- 27 • Creates hundreds of new “green” jobs for the State of Arizona;
- 28 • Sends customers correct price signals; and

- 1 • Enhances APS’s financial condition, thus enabling APS to continue to provide
2 reliable electric service and promote the energy future the Agreement
3 envisions.

4 Several of these benefits could not have or are unlikely to have resulted from
5 litigation. Indeed, several of the Agreement’s provisions required significant concessions
6 from APS that the Company would have been unwilling to make outside of the settlement
7 context and that could not be imposed upon APS absent its agreement. That a settlement of
8 such breadth and support was reached is a feat that has been lauded both inside and outside
9 the State and is a fact that is certainly supportive of the public interest. To cite one
10 example, the Arizona Republic editorial that ran on August 30, 2009 under the headline
11 “*Unusual Unity on Rate Increase Good for State*” specifically noted that, “[e]ven though
12 it’s a bad time for any rate hike, the proposal on the table has a lot to offer Arizonans in
13 terms of better and more.” Editorial, *Unusual Unity on Rate Increase Good for State*,
14 ARIZONA REPUBLIC, August 30, 2009.

15 Not approving the Agreement, on the other hand, would make it almost certain that
16 the Company will be downgraded to non-investment credit grade – an opinion expressed by
17 the financial experts who testified on that subject. See Dr. Johnson Testimony, Tr. at 1956
18 (noting that, under current economic circumstances, ratings agencies “would much more
19 likely go ahead and lower the rating based on an adverse order that they perceive is
20 adverse.”); Hatfield Testimony, Tr. at 2488-2489. Such an event would be no less than
21 catastrophic – dramatically increasing customer costs and effectively freezing Arizona’s
22 energy policy. See Dr. Johnson Testimony, Tr. at 1919; Hatfield Testimony, Tr. at 2370-
23 2371 and 2525; Guldner Testimony, Tr. at 1080; Smith Testimony, Tr. at 1715.

24 As RUCO’s expert Dr. Johnson testified, “ultimately the question, the test for this
25 Commission, is [the rate increase] a fair, just, and reasonable price to pay for the service
26 being provided.” Dr. Johnson Testimony, Tr. at 1917. The undisputed evidence presented
27 during the many days of hearing in this matter makes clear that the answer to that question
28 is an unqualified and resounding “yes.” The Agreement as a whole clearly supports the

1 public interest, propels Arizona energy policy forward, and should thus be approved as
2 proposed.

3 **II. THE SETTLEMENT AGREEMENT PROMOTES THE PUBLIC INTEREST**
4 **AND SHOULD BE APPROVED**

5 **A. The Positive Benefits to Customers that Will Result from the Agreement**
6 **Balance the Proposed Rate Increase.**

7 *“Negotiation is a process of give and take. We gave a little; we took a lot.”*

8 - Abinah Testimony, Tr. at 1801–1802.

9 Unlike settlements often reached in rate cases, the Agreement presented to the
10 Commission here goes well beyond simply proposing an acceptable revenue requirement.
11 See Dr. Johnson Testimony, Tr. at 1920; Higgins Testimony, Tr. at 237; APS Exhibit 12 at
12 8-9. Instead, given the current economic climate and the importance of emerging policy
13 developments to the nation’s changing energy landscape, the Settling Parties strategically
14 designed the Agreement to promote Arizona’s energy future and provide other tangible
15 benefits to APS customers with as little financial impact to them as possible. See
16 Agreement at § 1.16. And it succeeded, in the following notable ways.

17 **1. Providing Rate Stability**

18 *“One of the primary benefits of this Agreement is Rate Stability.”*

19 - Jerich Testimony, Tr. at 2319.

20 There is no disputing the severe impact that the current economic recession has been
21 and is having on APS, its customers, and other interested parties – a fact expressly
22 acknowledged in the Agreement. See Agreement at § 1.7. At the same time, the Settling
23 Parties recognized that current APS prices are below its reasonable costs and that, absent a
24 settled resolution, the Company would have continued filing rate cases incessantly in an
25 effort to improve its financial condition. See Abinah Testimony, Tr. at 1804; Guldner
26 Testimony, Tr. at 1029; Hatfield Testimony, Tr. at 2364-2365.

27 But a constant string of rate proceedings benefits no one, as the Settling Parties well
28 understood. It consumes the scarce resources of the Commission and other interested

1 parties. *See* Jerich Testimony, Tr. at 2344; Yaquinto Testimony, Tr. at 2271. It distracts
2 the Company's ability to focus on operational matters and important policy issues. *See*
3 Direct Settlement Testimony of James Hatfield (APS Exhibit 31) at 5. And it makes it
4 difficult for customers to predict (and control) the size of their energy bills as they manage
5 their household budgets – an especially weighty consideration in tough economic times.
6 *See* Jerich Testimony, Tr. at 2321.

7 For these reasons, a key benefit of the Agreement is that it provides a level of base
8 rate stability for customers and all interested stakeholders. It does so in two ways. First, it
9 establishes a “Rate Case Filing Plan” that governs APS rate applications until
10 December 31, 2014. *See* Agreement at § 2.1; Guldner Testimony, Tr. at 1029; APS
11 Exhibit 12 at 3. Pursuant to this Plan, APS is prohibited from filing another general rate
12 case until June 1, 2011. *See* Agreement at § 2.1. The earliest that customers will see
13 another rate increase is July 1, 2012 – **two and a half years** after the proposed effective
14 date of the rate increase from this proceeding. *Id.* Thereafter, APS is barred from filing its
15 next general rate case until June of 2013, which will again take at least a year to process
16 under the very best of conditions. *Id.*; Guldner Testimony, Tr. at 1262; Hatfield
17 Testimony, Tr. at 2365-2366. As AECC Witness Kevin Higgins testified, “[t]his stay out
18 will provide customers with an assurance that stable base rates will continue for a
19 considerable period. In my opinion, this is a material benefit to customers.” Higgins
20 Testimony, Tr. at 239.

21 Moreover, the Agreement proposes that the Company accelerate the reset of its
22 Power Supply Adjustor (“PSA”) to correspond with the effective date of new rates, thus
23 using the credit to customers currently in that account to offset the base rate increase
24 resulting from this case. *See* Agreement at § II.B. This provision benefits customers by
25 significantly reducing the bill impact resulting from the proposed resolution of this
26 proceeding. If the PSA reset is timed with the effective date of new rates as proposed, the
27 average residential customer bill will actually **decrease** by a small amount (about 35 cents)
28 in January. *See, e.g.,* Jerich Testimony, Tr. at 2326; Guldner Testimony, Tr. at 1220; APS

1 Exhibit 30. Residential customers will not see any rise in their electric bills from the base
2 rate increase until May, when the normal transition to higher summer rates occurs. *See*
3 Pierce Exhibit 3. Overall, the net annual rate increase resulting from the Agreement is still
4 less than one percent – a smooth transition during difficult economic times. *See, e.g.,*
5 Jerich Testimony, Tr. at 2318; Guldner Testimony, Tr. at 1220; Hearing Testimony of
6 David Rumolo (“Rumolo Testimony”), Tr. at 2170; Higgins Testimony, Tr. at 329; APS
7 Exhibit 30.

8 Economic indicators suggest that the economy should improve over the next several
9 years, *see* Hearing Testimony of APS Witness Peter Ewen (“Ewen Testimony”), Tr. at 812,
10 and the rate stability granted customers during this period is an important benefit that will
11 help them manage their budgets until it does, *see* Jerich Testimony, Tr. at 2321. For this
12 reason, the base rate stability provision was of the utmost importance to RUCO, the state
13 agency whose dedicated purpose is to represent residential ratepayer interests in utility
14 proceedings. As Jodi Jerich, Director of RUCO, testified:

15 RUCO’s statutory mission is to represent the Arizona families and
16 individuals who are immediately impacted by the recession. They are the
17 ones that are seeing the skyrocketing foreclosure rates, the high
18 unemployment levels that are making every dollar count for the Arizona
19 family. So in light of these tough economic times, RUCO supports the
20 settlement agreement in its entirety. . . .

21 I can’t stress enough how important the rate stability provisions were in
22 RUCO’s opinion in agreeing to the settlement agreement . . . We believe
23 that rate stability is an important ratepayer benefit. It gives ratepayers a rest
24 from the constant rate increases we’ve seen in recent years. And certainly
25 in these tough economic times, having predictability in their largest utility
26 bill is definitely a ratepayer benefit.

27 Jerich Testimony, Tr. at 2321.

28 **2. Increasing the Transparency of APS’s Accountability**

“The beauty of the benchmark section of the Agreement is that you have both parties going into it and agreeing upon specific criteria, specific factors to be measured and monitored. So we are going to move away from rhetoric and away from suspicion and into a world of facts”

1 - Dr. Johnson Testimony, Tr. at 1936.

2 Another central theme of settlement negotiations was the transparency of APS's
3 internal efforts to improve its financial condition. *See* Dr. Johnson Testimony, Tr. at 1936-
4 1939; Jerich Testimony, Tr. at 2314. Although APS has historically engaged in aggressive
5 cost management, its efforts in that regard may not have been as apparent to the
6 Commission and other parties as they might desire. *See* Dr. Johnson Testimony, Tr. at
7 1936; APS Exhibit 12 at 10; APS Exhibit 31 at 14.

8 And while various discrete aspects of the Company's business (such as its fuel
9 procurement and hedging practices and system operations) have been audited by the
10 Commission in the past to favorable reviews, neither APS nor the Settling Parties have had
11 an independent, comprehensive overview of the Company's operations to which they could
12 point to show that APS is a well-run company that it is doing its part to hold costs down.
13 *See* Dr. Johnson Testimony, Tr. at 1936 (noting that performance measures were important
14 to RUCO primarily "to get away from this situation in which there is a lot of sort of
15 suspicion on both sides, where perhaps management has a tendency to think that all their
16 problems are due to the unwillingness of the Commission to process rate cases as fast as
17 perhaps the company would like to see them processed or unwillingness of RUCO to agree
18 to rate increases of the magnitude management would like to see, but conversely, from the
19 other parties' points of view, a suspicion are you really holding your costs down as much
20 as you should be, are you really making the tough decisions"); Direct Settlement
21 Testimony of APS Witness James Hatfield (APS Exhibit 31) at 14 ("[The Agreement]
22 requires the Company to undergo a benchmarking analysis and report on several
23 operational areas, a provision that the Company views as a tremendous opportunity to put
24 to rest any concerns about the adequacy of APS's operational strength and cost
25 management.").

26 In this regard, the Agreement does four key things. First, it requires APS to
27 eliminate annual expenses by an average \$30 million each year (with a minimum floor of
28 \$25 million) throughout the Agreement's term, thus removing a total of \$150 million from

1 the Company's cost structure, and to report back annually to the Commission on the nature
2 and level of those reductions. *See* Agreement at § VII. This provision extends,
3 complements, and increases the similar cost reduction requirement ordered for 2009 in the
4 Company's interim rate case. *See* Decision No. 70667 at 4 (December 24, 2008);
5 Agreement at § 7.1.

6 As in the interim rate order, the areas from which APS can count reductions include
7 both operational and what may be classified as "non-operational" expenses and below-the-
8 line expenses. *See* Decision No. 70667 at 44; Hatfield Testimony, Tr. at 2564-2565; Jerich
9 Testimony, Tr. at 2332; Dr. Johnson Testimony, Tr. at 2037-2038; Guldner Testimony, Tr.
10 at 1199-1201. They would not, however, include reductions in construction expenditures,
11 deferrals of any expense to a subsequent period, or any expense reduction that is
12 specifically called for elsewhere in the Agreement (such as the depreciation expense
13 reduction that would result from the license renewal at Palo Verde by virtue of Section XI.)
14 *See* Guldner Testimony, Tr. at 1087 and 1201; Abinah Testimony, Tr. at 1827; Dr. Johnson
15 Testimony, Tr. at 2036-2037; Jerich Testimony, Tr. at 2332-2334; Higgins Testimony, Tr.
16 at 301. Nor can they include any reductions in costs necessary to preserve safe and reliable
17 electric service. *See* Agreement at § 7.4.

18 This provision clearly benefits customers by reducing the Company's future revenue
19 requirement. *See* Settlement Testimony of RUCO Witness Dr. Ben Johnson (RUCO
20 Exhibit 5) at 31; Jerich Testimony, Tr. at 2333; Hatfield Testimony, Tr. at 2435. Another
21 benefit results as well. Because APS is required to report annually on its expense
22 reductions in similar detail and format to the filing ordered in the interim rate matter, *see*
23 Agreement at § 7.3, the transparency of the Company's cost reduction efforts will increase,
24 hopefully relieving some potential conflict between APS and other participants and
25 facilitating the resolution of future filings. *See* Dr. Johnson Testimony, Tr. at 1936.

26 Second, the Agreement requires APS to fund a comprehensive benchmarking
27 analysis of the Company's operations, in which a Staff-selected benchmarking firm will
28 analyze APS's cost and operational performance in numerous areas (identified in Section

1 13.7) and compare the Company's performance to a peer group of other investor-owned,
2 electric utility operating companies. *See* Agreement at §§ 13.6 and 13.7; Direct Settlement
3 Testimony of APS Witness Jeffrey Guldner (APS Exhibit 12) at 20. A "Benchmark Study
4 Report" will be submitted to the Commission no later than December 31, 2010, and will
5 discuss the firm's conclusions about the Company's performance and identify areas where
6 that performance appears to be significantly above or below the norm. *See* Agreement at §
7 13.9; APS Exhibit 12 at 20. This information will be available to the Commission and
8 other interested parties when considering the Company's next rate case. *Id.*

9 Third, the Agreement requires APS to undergo periodic performance evaluations
10 related to a detailed list of "Performance Measurements." *See* Agreement at § XIII(A).
11 This provision allows the Commission to annually evaluate the Company's compliance
12 with certain key areas of the Agreement, including the expense reduction requirement, the
13 energy efficiency and renewable energy sections, and the equity infusion and related
14 financial provisions. *See* Agreement at § 13.2. If APS does not achieve any one of the
15 Performance Measurements applicable to the year in question (or secure a hardship waiver
16 from the Commission from doing so), the Company cannot recover the annual cash
17 incentive compensation paid to APS executives (or their functional equivalent) above the
18 test year level for the year in question. *See* Agreement at § 12.2; 13.2; APS Exhibit 12 at
19 21.

20 Finally, the Agreement commits APS to extensive reporting requirements, pursuant
21 to which APS must report at least annually (and in some cases quarterly) on a
22 comprehensive and detailed list of customer service, reliability, safety, and financial
23 information. *See* Agreement at § 13.4. This information will be submitted to the
24 Commission in at least one annual report (some of the provisions require more frequent
25 reporting), thus providing greater transparency regarding the Company's operations to the
26 Commission and other interested parties. *See* Agreement § 13.5; Direct Settlement
27 Testimony of RUCO Witness Jodi Jerich (RUCO Exhibit 1) at 6.

28 Collectively, these provisions provide the Commission and interested parties with a

1 wealth of tools and data to assess the Company's performance in a variety of areas and
2 incent APS to continue to excel, all of which will ultimately inure to the benefit of
3 customers. See Dr. Johnson Testimony, Tr. at 1936-1937; Jerich Testimony, Tr. at 2313-
4 2316; APS Exhibit 12 at 22; Guldner Testimony, Tr. at 1251; APS Exhibit 31 at 14.

5 3. Setting Ambitious Energy Efficiency Measures

6 *"These provisions are a major step forward for cost effective energy efficiency in*
7 *Arizona and are in the public interest."*

- 8 - Hearing Testimony of Southwest Energy Efficiency Project ("SWEEP")
9 Witness Jeff Schlegel ("Schlegel Testimony"), Tr. at 1344.

10 Another significant benefit of the Agreement is that it establishes the first energy
11 efficiency standard for any Arizona utility that, if adopted by the Commission, will place
12 APS among the nation's leaders in energy efficiency deployment. See Agreement at § 14;
13 Schlegel Testimony, Tr. at 1344. If the Commission's current rulemaking process results
14 in an energy efficiency standard that exceeds the levels set forth in the Agreement, APS
15 will be required to abide by that rule instead. See Agreement at § 14.1; Direct Settlement
16 Testimony SWEEP Witness Jeff Schlegel (SWEEP Exhibit 2) at 7.

17 The Agreement calls for new energy efficiency programs and enhancements to
18 existing programs that will benefit existing residential homes, residential homes that will
19 be constructed in the future, limited-income customers, existing businesses of all types and
20 sizes, municipalities and schools. See Agreement at § 14; Hearing Testimony of APS
21 Witness James Wontor ("Wontor Testimony"), Tr. at 1646. These programs will not only
22 allow customers to save money in the immediate future but could, in the long run, reduce
23 the need for new generation to a degree that will produce savings for all APS customers.
24 See SWEEP Exhibit 2 at 3-4. In fact, "by taking some of the simple energy saving steps in
25 their homes and in their business facilities, both residential and business customers will
26 have the opportunity to save significantly more on their energy bill than the amount of rate
27 increase requested in the settlement." Wontor Testimony, Tr. at 1646.

28 APS agreed to these heightened energy efficiency levels notwithstanding the fact

1 that the Agreement prohibits it from recovering all of the fixed costs that APS rates are
2 designed to collect and which will thus be foregone due to the higher energy efficiency
3 measures (a significant disincentive toward energy efficiency programming). *See* Wontor
4 Testimony, Tr. at 1660-1663. Nor can APS request permission to recover such costs as a
5 component of its DSM program costs until its next general rate case. *See* Agreement at
6 § 14.8.

7 The Agreement also introduces innovative demand response rate programs that will
8 allow customers able and willing to shift their usage away from the highest load peaks to
9 see significant savings on their energy bills. *See* Agreement at § 20; APS's August 18,
10 2009 Response to Chairman Mayes's August 5, 2009 Letter. These programs include a
11 critical peak pricing program for general service and irrigation customers, a residential
12 critical peak pricing program, and a new residential time of use rate that introduces a
13 "super peak" period (from 3:00 pm to 6:00 pm) during the most critical summer months.
14 *See* Agreement at § 20. APS estimates that these rates could result in a substantial
15 megawatt savings during the Company's peak times. *See* APS's August 18, 2009
16 Response to Chairman Mayes's August 5, 2009 Letter.

17 To better understand the impact of these programs, the Agreement also requires
18 APS to prepare and file a study that examines their effect on the Company's resource
19 portfolio, air emissions, and program participant energy use. *See* Agreement at § 20.6;
20 APS's August 18, 2009 Response to Chairman Mayes's August 5, 2009 Letter. The
21 Agreement further requires APS to develop an interruptible rate schedule to similarly
22 encourage energy and demand savings at peak periods. *See* Agreement at § XIX; APS's
23 August 18, 2009 Response to Chairman Mayes's August 5, 2009 Letter. Although APS
24 believes that demand response is an important resource that can economically meet a
25 portion of the Company's future peaking resource needs, additional demand response
26 programs beyond those contemplated by the Agreement are simply not necessary in the
27 near-term. *See* APS's August 18, 2009 Response to Chairman Mayes's August 5, 2009
28 Letter.

1 4. **Requiring Large-Scale Renewable Resource Investments**

2 *“[O]n the renewable energy side, this has been alluded to as well, but this is*
3 *huge. I mean, you just can’t overstate this. APS has committed to obtaining 10*
4 *percent of its resources from renewable energy by 2015. That is a major, major*
5 *commitment.”*

6 - Opening Statement of Tim Hogan, on behalf of Western Resource
7 Advocates (“WRA”), Tr. at 148.

8 Additionally, the Agreement requires APS to make considerable investments in
9 renewable energy such that – by 2015 – an estimated 10% of the Company’s retail sales
10 will come from renewable resources. See Agreement at § 15.1. In this vein, the
11 Agreement obligates APS to acquire renewable resources that would **double** the
12 requirement of the Commission’s RES by 2015, mandating the Company to bring to the
13 Commission, among other things, a project for in-state wind generation, a plan for a utility-
14 scale photovoltaic generation project, ambitious solar programs for Arizona schools and
15 governmental institutions, and a renewable transmission project. See Agreement at § 15;
16 Hearing Testimony of APS Witness Barbara Lockwood (“Lockwood Testimony”), Tr. at
17 1518; Direct Settlement Testimony of WRA Witness David Berry (WRA Exhibit 2) at 3.

18 These provisions are not loose promises. Every witness who testified on this issue
19 assured the Commission that the renewable energy provisions are hard-and-fast obligations
20 by APS to take diligent action to bring the projects identified in the Agreement to fruition,
21 thwarted only by external commercial barriers or a Commission decision that such projects
22 should not move forward. See Guldner Testimony, Tr. at 1102; Berry Testimony, Tr. at
23 1279-1280; Hearing Testimony of Interwest Energy Alliance (“Interwest”) Witness
24 Amanda Ormond (“Ormond Testimony”), Tr. at 1390-1391; Lockwood Testimony, Tr. at
25 1512, 1516-1517.

26 Although the phrase “best efforts” is used with respect to certain provisions, that
27 legal standard does not somehow undercut the fact that APS is contractually bound and
28 will be required by its regulators to work hard to make these projects happen. “The duty of
 best efforts has diligence at its essence and is more exacting than the usual contractual duty

1 of good faith.” *See Dialog4 System Engineering GmbH v. Circuit Research Labs, Inc.*, 622
2 F. Supp 2d 814, 821 (D. Ariz. 2009) (internal citation omitted). Bound by such standard,
3 APS could not legally avoid investing in the renewable energy projects called for by the
4 Agreement “simply because it would not have been profitable for [APS] to continue to
5 fulfill its obligation to do so.” *Id.*

6 Neither did APS or the Settling Parties intend otherwise. Rather, the term was
7 intended only to recognize that conditions may arise – such as the Commission’s rejection
8 of a proffered project or intervening market barriers (a third party contractor’s default on
9 an already approved project, for example) – that might make the provision impossible to
10 fulfill. *See Berry Testimony, Tr. at 1280; Ormond Testimony, Tr. at 1391.* Because APS’s
11 fulfillment of these provisions is a Performance Measurement, *see Agreement at § 12.2(a)*
12 *and 13.2(d)*, the Settling Parties recognized that the Company should not be unfairly
13 penalized if circumstances outside of its control made compliance with the provisions
14 unachievable. *See Berry Testimony, Tr. at 1291; Ormond Testimony, Tr. at 1390-1391.* In
15 the end, whether APS has actually used its “best efforts” to make these projects happen is a
16 question for and will be decided by the Commission. *See Dialog4*, 622 F. Supp. 2d at 821
17 (a dispute over whether a party has used its “best efforts” is resolved by the fact finder);
18 Lockwood Testimony, Tr. at 1637-1638.

19 5. Protecting APS’s Most Vulnerable Customers

20 *“Based on the need that we’re seeing and the issues that the communities are*
21 *facing, we believe that these programs are more important now than ever before.*
22 *And as a result of these items being accepted within the context of this proposed*
23 *settlement, this actually is a win/win for the company. You know, members of*
24 *the community are able to pay their bills, can stay housed. It’s good for the*
25 *families, and it’s good for the communities overall.”*

26 - Hearing Testimony of Cynthia Zwick (“Zwick Testimony”), Tr. at 134.

27 Recognizing that the Company’s low-income customers are particularly vulnerable
28 to even very modest increases in energy bills, particularly in the current economic climate,
the Agreement takes several measures designed to insulate the most impoverished in the

1 community from the increasing cost of energy.

2 Specifically, consistent with the Commission's direction with the interim order in
3 this docket, the rate increase resulting from the Agreement would not apply to rate
4 schedules E-3 and E-4 (the Company's limited income rate schedules). See Agreement at
5 § 16.1. The Agreement also continues the exemption of limited-income customers from
6 the Company's Demand Side Management Adjustment Clause, consistent with the
7 Commission's direction in Decision No. 70961 (April 7, 2009). These provisions "hold
8 harmless" not only currently existing limited income customers but also those that may
9 ultimately be enrolled on the limited income rates, thus broadening the reach of this
10 exemption during these difficult economic times. *Id.*; Settlement Testimony of Cynthia
11 Zwick (Zwick Exhibit 2) at 2.

12 In addition, APS has agreed to donate \$5 million to augment its current bill
13 assistance program for the purpose of providing bill assistance to customers whose
14 incomes fall between 150% and 200% of the federal poverty level. See Agreement at
15 § 16.3. This amount will be more than adequate to fund the program through the term of
16 this Agreement (*see* Guldner Testimony, Tr. at 1034), and any remaining funds will carry
17 forward after that time until they are depleted. See Agreement at § 16.3. This contribution,
18 coupled with the provisions of Section 16.4 requiring APS to waive the collection of an
19 additional security deposit from customers on rate schedules E-3 and E-4 under specified
20 conditions, may prevent a financially distressed customer from being disconnected for non-
21 payment or to help that customer become reconnected. See Zwick Exhibit 2 at 3.
22 Collectively, these provisions give much-needed support to the limited-income community,
23 helping them stay current on their electric bills and keeping the lights on.

24 6. Creating Green Jobs

25 *"[H]ow do you get these high-paying, well-trained, green-collar jobs? They*
26 *don't just fall from the sky. It takes effort on somebody's part to make that*
27 *actually happen. And I'm here before you today on behalf of my clients to tell*
28 *you that we believe that this settlement does move the ball forward in a*
demonstrable way, both in the short-term and it gets us on a glide path into the
future to promote this industry and to actually promote these kind of high-

1 *paying, quality jobs that we're looking for."*

- 2 - Opening Statement of Nicholas Enoch on behalf of the International
3 Brotherhood of Electrical Workers, AFL-CIO, CLC ("IBEW"), Tr. at
4 126.

5 The Agreement also brings less transparent, but equally important, benefits to the
6 State of Arizona. For example, in addition to the primary environmental benefit, the
7 requirement of Section 15.2 obligating APS to bring to the Commission for its review a
8 project for in-state wind is also expected to create anywhere from 45 to 75 construction
9 jobs and 6 to 15 permanent plant jobs. *See* Hatfield Testimony, Tr. at 2561. Similarly, the
10 utility-scale photovoltaic plant contemplated in Section 15.3, if approved by the
11 Commission, could result in the creation of 175 to 325 construction jobs and the addition
12 of 5 to 10 permanent plant personnel. *See id.* Thus, if the Commission approves the
13 Agreement, it would not only promote the use of green energy but would create some 425
14 new green jobs for the State of Arizona, not including any generated from the other non-
15 specified renewable projects needed to meet the requirements of Section 15.1.

16 **7. Sending the Right Price Signals**

17 *"This agreement also improves price signals to customers by bringing the rates*
18 *that they pay closer to the true costs of the product, electricity, thereby further*
19 *promoting the benefits of energy efficiency."*

- 20 - Hatfield Testimony, Tr. at 2406.

21 Another important aspect of the Agreement is that its resulting rates will send
22 correct price signals to customers, encouraging them to more efficiently and rationally
23 manage their energy usage and take advantage of the Company's existing demand-side
24 management measures to keep their bills down. To the extent practicable, base rates
25 should send customers market price signals that will shape their usage patterns and better
26 reflect the costs incurred to serve them. *See* Pierce Exhibit 3; APS Exhibit 12 at 8. Indeed,
27 this is the express purpose behind time-of-use and similar demand response rate schedules.
28 Such a practice makes good sense. As APS Witness Jim Hatfield noted in his Direct
Settlement Testimony, "To reduce vehicle emissions, one would not decrease the price of

1 gas; doing so would send entirely the wrong message. To encourage energy efficiency,
2 among other things, customers should know and be required to pay the real cost of
3 electricity, not a subsidized one.” APS Exhibit 31 at 19.

4 The prices that customers pay APS today for electricity do not accurately reflect the
5 costs that APS incurs to serve them. This fact was recognized by each of the Settling
6 Parties. Although the Agreement’s proposed rates still will not wholly align the
7 Company’s costs with its prices (APS will still have a revenue requirement deficiency of
8 \$80 million in 2010, even taking into account the required \$30 million expense reduction
9 for that year), the increase nevertheless sends customers a more accurate message about
10 how much electricity costs, thus incenting them to participate in the robust energy
11 efficiency programs contained in the Agreement. *See* Hatfield Testimony, Tr. at 2367.

12 **8. Enhancing APS’s Financial Condition**

13 *“It takes a strong – a financially strong utility to be on the cutting edge and to*
14 *have [the] kind of aggressive energy goals that are set forth in this Agreement.”*

15 - Dr. Johnson Testimony, Tr. at 2070.

16 Finally, and perhaps most significantly, the Agreement takes critical steps toward
17 improving the Company’s financial health, thus enabling APS to continue to provide
18 reliable electric service and promote the energy future the Agreement envisions. To
19 understand why this is so, it is important to put the Company’s cost pressures in their larger
20 financial context.

21 Like APS, utilities across the country are looking for ways to improve their own
22 distribution, transmission, and generation systems such that they will be less costly to
23 maintain, more energy efficient and reliable, and more “green.” As APS Witness Jim
24 Hatfield testified, over the course of just the next five years – the term of this Settlement
25 Agreement – the electric industry (not including APS) will need to issue \$20 billion in new
26 equity to support the infrastructure development underway across the nation. *See* Hatfield
27 Testimony, Tr. at 2388-2389.

28 Between now and 2025, APS estimates that its customer base will grow by almost

1 600,000, rendering a total customer count of close to 1.7 million, resulting in capital needs
2 of more than \$15 billion – a number that does not include any cost increases associated
3 with potential climate change legislation. *See* APS Exhibit 31 at 7. And, as RUCO
4 Witness Dr. Ben Johnson explained, APS cannot avoid these upward cost pressures:

5 When you are in a growth state, you are in a position of having to invest in
6 new plant and new equipment. And it is unfortunate, but the reality [is] that
7 in the electric industry, new plant and equipment tends to cost quite a bit
8 more than what was being purchased 10 or 15 years ago. **So it is really
9 unavoidable that you are going to have upward cost pressures when
10 you are in a state like Arizona.**

11 Dr. Johnson Testimony, Tr. at 1922.

12 To use the well-put phrase of AIC counsel Mike Grant, APS is thus in a “high-
13 stakes competition for capital” with others in the electric utility business. *See* Opening
14 Statement of Mike Grant on behalf of AIC, Tr. at 84. The Company’s ability to compete
15 effectively for capital investment will thus determine whether it is able to finance the
16 improvements needed to maintain its aging electric system and make the investments
17 necessary to make the policy goals inherent in the Agreement a reality. *See* APS Exhibit
18 31 at 15; Yaquinto Testimony, Tr. at 2257. The equity market is not limitless, and the
19 current market has proven to be relatively risk averse in the recent past, having taken a
20 “flight to quality” as a result of the economic crisis. *See* Dr. Johnson Testimony, Tr. at
21 1926.

22 Against this backdrop, APS’s odds of securing debt and equity capital on reasonable
23 terms given its current financial condition are not good. The Company is rated BBB- by
24 Standard & Poor’s, just one notch from non-investment grade. *See* Smith Testimony, Tr. at
25 1715; Higgins Testimony, Tr. at 315. Out of 141 rated investor-owned utilities, **only one**
26 **has a credit rating worse than APS.** *See* APS Exhibit 34; APS Exhibit 39; Hatfield
27 Testimony, Tr. at 2392. As RUCO expert Witness Dr. Ben Johnson testified,

28 “[t]hat is not a position you want to be in. It is nice to be at the head of
29 your class. It is not so good to be at the bottom of your class. And it is not
30 so good at a time when the rating agencies were under and continue to be

1 under significant scrutiny from the government They are under
2 tremendous pressure right now to be very tough and accurate, and fair, but
3 to be tough. And so then you don't want to be in a borderline situation."

4 Dr. Johnson Testimony, Tr. at 1924.

5 APS's precarious bond rating also significantly increases the Company's cost of
6 debt, which is ultimately passed to customers. *See* Higgins Testimony, Tr. at 315; Dr.
7 Johnson Testimony, Tr. at 1927; Hatfield Testimony, Tr. at 2477-2478. Indeed, of the 79
8 long-term debt issues in the industry in 2009, only three had a higher credit spread and
9 were thus more costly than that of APS. *See* Hatfield Testimony, Tr. at 2392. If APS is
10 downgraded to junk, those financing costs will increase exponentially and there is a
11 significant likelihood that APS will be unable to obtain capital at all. *See* APS Exhibit 31
12 at 20; Dr. Johnson Testimony, Tr. at 1926. As Dr. Johnson testified, "we can't just assume
13 that if they lose the bond rating all will be well." Dr. Johnson Testimony, Tr. at 1926.

14 In the equity market, APS's ability to compete for capital depends entirely upon the
15 actual returns that it provides to investors. *See* APS Exhibit 31 at 17; Guldner Testimony,
16 Tr. at 621. Like debt lenders, equity investors require a payback on their investments from
17 an existing revenue stream, and APS must prove the existence of a reliable source of
18 income to attract equity investment. *See* Hatfield Testimony, Tr. at 2388; Direct
19 Settlement Testimony of AIC Witness Gary Yaquinto (AIC Exhibit 1) at 4. If the
20 Company's actual returns compare unfavorably to similarly situated equity security issuers,
21 investors will turn to others in their portfolio of options from which they will receive a
22 higher return. *See* Hatfield Testimony, Tr. at 2388; AIC Exhibit 1 at 4; Dr. Johnson
23 Testimony, Tr. at 2068 ("The bottom line matters a lot. If you earn 11 or 12% in one
24 company and another company is only earning 8 or 9, obviously the stock that's earning 11
25 or 12 is more attractive than the one that is earning 8 or 9"). It is these actual earnings that
26 are primarily important to investors, not just what a utility is authorized to earn. *See* Dr.
27 Johnson Testimony, Tr. at 2007 ("Folks on Wall Street are going to pay attention to the 12
28 that they actually earned and not the fact that the order said 4. Or vice versa.").

1 As the evidence in the record makes plain, the Company's historical earned returns
2 on equity do not give the Company much of a competitive footing. See APS Exhibit 35;
3 Hatfield Testimony at 2393-2394. In 2004, when the industry earned 10.6% on average,
4 APS earned only 8.9%. *Id.* In 2005, when the industry earned 9.8% on average, APS
5 earned only 6.6%. *Id.* In 2006, when the industry earned 10.5% on average, APS earned
6 only 8.8%. *Id.* In 2007, when the industry earned 10.4% on average, APS earned only
7 8.7%. *Id.* Last year, when the industry earned 9.8% on average, APS earned only 7.6%.
8 *Id.* These historical trends only worsen going forward without rate relief, falling to the five
9 percent range in 2010. See APS June 2, 2008 Rate Application, SFR Schedule A-2.

10 The Agreement contains four key provisions that, together, are designed to move
11 APS's financial metrics in the right direction to help the Company succeed in its
12 nationwide competition for capital. First, it provides for a base rate increase that should be
13 adequate for the first phase of the Agreement to allow the Company to maintain investment
14 grade ratings and begin to implement the Agreement's energy efficiency, renewable
15 energy, and related provisions. See Agreement at § III; Abinah Testimony, Tr. at 1803;
16 Smith Testimony, Tr. at 1715-1716. Second, it requires APS to eliminate expenses by a
17 total of \$150 million over the term of the Agreement, as previously discussed. See
18 Agreement at § VII. Third, it obligates APS to "use its best efforts to improve its financial
19 metrics and bond ratings, by completing timely equity infusions and taking other measures
20 to strive to achieve a capital structure with no more than 52% debt/total capital as
21 calculated by the rating agencies, by December 31, 2012," and specifically requires equity
22 infusions totaling at least \$700 million by year-end 2014. See Agreement at §§ 8.1 and 8.3.
23 Finally, it provides additional earnings support in three innovative forms: the revenue
24 treatment of APS line extension proceeds, the deferral of a portion of the Company's
25 increasing pension and OPEB costs, and an adjustment to the depreciation rates applied to
26 Palo Verde reflecting a potential license extension. See Agreement at §§ IX, X, and XI.

27 Collectively, as discussed in detail in Section C below, these provisions comprise
28 the "economic package" of the Agreement, each component of which is material. See

1 Hatfield Testimony, Tr. at 2493; Guldner Testimony, Tr. at 1136-1137; Smith Testimony,
2 Tr. at 1715-1716. Together, the economic package raises APS's expected ACC-
3 Jurisdictional returns on equity to 9.4% in 2010, 8.4% in 2011, and 8.1% in 2012 – still
4 well below industry average and even further below the 11% cost of equity proposed by the
5 Agreement, but enough of an improvement in the Company's financial picture to allow
6 APS to abide by the two-and-a-half-year stay out and compete for the capital needed for
7 APS to make the investments that will provide the foundation for Arizona's energy future,
8 to the benefit of all of Arizona. See APS Exhibit 31 at 14; Hatfield Testimony, Tr. at 2394-
9 2395; AIC Exhibit 1 at 4.

10 **B. APS Was Required to Make Numerous Concessions to Make This**
11 **Settlement Happen.**

12 *“Every last nickel was rung out of this deal on behalf of customers.”*

13 - Higgins Testimony, Tr. at 240.

14 Although settlement discussions in this matter were open and inclusive, the
15 resolution was by no means easily reached. See Abinah Testimony, Tr. at 1801. With each
16 proposal APS brought to the table, Staff participants Ernest Johnson and Elijah Abinah
17 pushed back with an analysis of what Mesquite Group counsel Larry Robertson referred to
18 during the hearing as the “the ratepayer litmus test”: (1) will the proposal impact
19 ratepayers; (2) if so, how and why; and (3) if so, what other provisions could mitigate or
20 offset that impact so that ratepayers benefit overall. See Abinah Testimony, Tr. at 1809.

21 The consequence of Staff's approach was that APS was required to make significant
22 concessions to make the deal happen. Although Section 24.4 of the Agreement prohibits
23 APS from disclosing several of these concessions, many others are obvious on the face of
24 the Agreement itself. These include, for example, a base rate increase that is \$104 million
25 less than the amount that APS originally requested and that leaves APS with an \$80 million
26 revenue requirement deficiency for 2010 (a deficiency that considerably worsens in 2011
27 and 2012, during which APS is prevented by the Agreement from receiving new base rate
28 relief until at least mid-2012), see Abinah Testimony, Tr. at 1802, Hatfield Testimony, Tr.

1 at 2567-2568; the withdrawal of APS's proposed impact fee in compromise for the revenue
2 treatment of its line extension policy proceeds, *see* Agreement at § X; mandatory expense
3 reductions of \$30 million per year for the term of the Agreement, for a total of at least \$150
4 million, *see* Agreement at § VII; the retention of the 90/10 sharing provision in the PSA,
5 which has historically caused APS to absorb millions of dollars in presumptively prudent
6 fuel costs, *see* Agreement at § 6.1; mandatory equity infusions and other financial
7 obligations, *see* Agreement at § VIII; funding by APS, not to be recovered in rates, of a
8 limited income assistance program and benchmarking study, *see* Agreement at §§ 16.3 and
9 13.8; a "stay out" of two-and-a-half years and further limitations on when APS may file its
10 next two general rate cases, *see* Agreement at § II(A); the establishment of "Performance
11 Measurements" that have consequences, *see* Agreement at § XIII(A); and a host of
12 reporting requirements, the extent of which has, to APS's knowledge, never before been
13 imposed on an Arizona utility, *see* Agreement at § XIII(B).

14 Other concessions are more hidden but just as real. APS, unlike Tucson Electric
15 Power, does not get to keep 50% of its gains on SO₂ allowances. *See* Yaquinto Testimony,
16 Tr. at 2260. APS has foregone some \$16 million in unrecovered fixed costs just for the
17 adjusted test year, a figure that will escalate dramatically in 2010, 2011, and 2012 (the first
18 year for which APS can seek recovery of such unrecovered costs as a component of DSM
19 program costs), due to the Agreement's ambitious energy efficiency measures. *See* Wontor
20 Testimony, Tr. at 1668; Settlement Testimony of Ralph Smith (Staff Exhibit 11) at 5-6.
21 APS has made concessions on its deposit program for limited income customers that will
22 produce an uncompensated increase in bad debt expense. *See* Rumolo Testimony, Tr. at
23 2149-2150. And APS will suffer uncompensated revenue erosion from reopening E-20 to
24 houses of worship without readjusting that now-frozen rate to reflect the current cost of
25 service. *Id.*

26 Yes indeed, the Settling Parties "took a lot." *See* Abinah Testimony, Tr. at 1802
27
28

1 **C. Each Component of the Proposed Rate Increase is Essential to the**
2 **Viability of the Agreement.**

3 *“[V]irtually every piece of this Agreement has a dollar impact.”*

4 - Higgins Testimony, Tr. at 313.

5 As previously mentioned, the economic package provided in the Agreement is
6 critical for APS to fulfill the commitments it has made in furtherance of Arizona’s energy
7 policy. That package was specifically engineered to keep the base rate increase to
8 customers as low as possible while funding the two-and-a-half year stay out period. *See*
9 Jerich Testimony, Tr. at 2323-2324; RUCO Exhibit 1 at 20-21; Higgins Testimony, Tr. at
10 237; APS Exhibit 12 at 14; Yaquinto Testimony, Tr. at 2263-2264. The fact that the
11 Agreement succeeded in aligning these goals is itself a remarkable achievement – one that
12 makes each part of that package, including the more innovative financial provisions in
13 Sections IX through XI, especially material. *See* Jerich Testimony, Tr. at 2319; RUCO
14 Exhibit 1 at 20-21; Higgins Testimony, Tr. at 299-301; Direct Testimony of AECC
15 Witness Kevin Higgins (AECC Exhibit 1) at 3-4; Hatfield Testimony, Tr. at 2493; APS
16 Exhibit 12 at 14-18; AIC Exhibit 1 at 5; Smith Testimony, Tr. at 423.

17 The Settling Parties’ design to keep the base rate increase to customers as low as
18 possible worked well. **Fit together, each piece of the Agreement’s economic puzzle**
19 **provides for a net annual increase to customer bills of less than one percent.** *See, e.g.,*
20 Jerich Testimony, Tr. at 2318; Guldner Testimony, Tr. at 1220; APS Exhibit 30. This
21 increase is well in line with – if not significantly below – those granted to other utilities
22 throughout the country, notwithstanding the current economic recession. *See* Guldner
23 Testimony, Tr. at 1023; Dr. Johnson Testimony, Tr. at 1948. It also compares favorably to
24 the general rate of inflation (particularly considering the fact that it supports a stay out of
25 two-and-a-half years). *See* Dr. Johnson Testimony, Tr. at 1919-22. And although the
26 proposed base rate increase includes some post-test year plant incurred through June 30,
27 2009, it does not include all of it. *See* Agreement at § 3.4; APS Exhibit 38. Significantly,
28

1 \$173 million worth of plant in which APS has already invested and that is now serving APS
2 customers is **not** included in the negotiated rate base. *See* APS Exhibit 38.

3 Another component of the revenue requirement is an authorized 11% cost of equity.
4 *See* Agreement at § 4.2. While some may believe such an authorized return to be high, that
5 number – originally proposed by Staff in the underlying rate case – is supported by all the
6 Settling Parties. *See* Direct Settlement Testimony of Staff Witness Ernest Johnson (Staff
7 Exhibit 10) at 16; AIC Exhibit 1 at 8. As RUCO’s expert Dr. Ben Johnson testified, “[t]here
8 was at least some plausible data suggesting a cost of equity for this Company could
9 conceivably be as high as 12-and-a-quarter. So if they earned 12.06, that’s not outside the
10 range of reasonableness. It’s not unfair to customers.” Dr. Johnson Testimony, Tr. at 2009.

11 In fact, APS has historically been allowed the opportunity to earn returns on equity at
12 levels far exceeding the 11% proposed here, with authorized ROEs as high as 16.15% and
13 16.5% in the not so distant past. *See* Hatfield Testimony, Tr. at 2555-2556. Neither is an
14 11% authorized return on equity unusually high compared to what other utilities nationwide
15 have the opportunity to earn. *See* Hatfield Testimony, Tr. at 2557-2558. Today, for
16 example, Alabama Power Company has an allowed ROE of 14.5%; Pacific Gas & Electric
17 has an authorized ROE of 11.35%; Georgia Power has an allowed ROE of 12.25%; and
18 Mid-American Energy’s authorized ROE is 12%. *See* Hatfield Testimony, Tr. at 2557-2558.
19 *Id.* Other examples abound. *Id.*

20 Moreover, there is no evidence in the record to suggest that APS will actually earn
21 anywhere near an 11% ROE. Quite the contrary. The record clearly establishes that APS
22 does not have a realistic opportunity to earn 11%, but will instead earn in the 8% and 9%
23 range. *See* Dr. Johnson Testimony, Tr. at 1949-1950, 2009; Hatfield Testimony, Tr. at 2445;
24 Smith Testimony, Tr. at 1714. In fact, even with the revenue increase granted in this
25 Agreement, APS would still have to cut costs by another \$80 million in 2010 on top of the
26 \$30 million expense reduction already required by the Agreement to achieve a return of
27 11%. *See* Hatfield Testimony, Tr. at 2567-2568. That level of cost reduction simply cannot
28 happen without jeopardizing reliability and laying off numerous APS employees. *Id.*

1 Another essential component of the Agreement's economic package is its
2 combination of "creative" financial measures: the revenue treatment of the Company's line
3 extension policy, Service Schedule 3 ("Schedule 3"); the deferral of certain pension and
4 OPEB costs; and a depreciation rate change reflecting an anticipated license extension at
5 Palo Verde. See Agreement at §§ IX, X, and XI. Each of these provisions is highly material
6 to APS's financial condition and all combine to close the gap between the Company's
7 minimal financial needs and the maximum base rate increase the Settling Parties were
8 willing to require of customers during the recession. See APS Exhibit 12 at 14-18; APS
9 Exhibit 31 at 15; AECC Exhibit 1 at 3-4; Jerich Testimony, Tr. at 2319.

10 As RUCO Witness Jodi Jerich testified, these innovative accounting measures are
11 important for three reasons:

12 First, while these certainly do benefit the company, they also help the
13 consumer because it keeps the rate increase to within acceptable limits. As
14 I said before, without these creative measures, it is unlikely that all of the
15 parties would have been able to find consensus on a revenue requirement.
16 Secondly, these elements allowed the companies to – allowed the parties to
17 put the company on a rate stability plan and freeze rates for two-and-a-half
18 years. And finally, these elements will help improve the company's
19 financial metrics and improve its credit ratings. This, in turn, will benefit
20 customers in future cases since a healthier utility will not need as high of a
21 rate increase in subsequent cases.

22 Jerich Testimony, Tr. at 2324.

23 Specifically with respect to the treatment of Palo Verde license extension
24 depreciation expenses, AECC Witness Kevin Higgins similarly noted that "the treatment of
25 Palo Verde life-extension costs represents a creative solution that bridges the litigation
26 differences among various other signatories to enable the crafting of a successful package.
27 This provision provides important benefits for customers without raising rates." Higgins
28 Testimony, Tr. at 240. RUCO's expert Witness Dr. Ben Johnson also testified that:

The depreciation - that was basically one of the devices used to help close
the gap in a resistance on certain participants not wanting to go any higher
than the 7.9 percent rate increase that was ultimately agreed upon[, which]
was about as far as some of the participants were willing to go. And APS

1 was just having trouble making the numbers work. They were well below
2 the 11% they were hoping to actually earn. When looking at the
3 projections, they were far below that. They were having trouble getting up
4 to the bare minimum they needed to in order to accept it. The provision on
5 depreciation was about a six-month provision, which was one of the steps
to doing that. But ultimately, of course, being able to depreciate the plant
over longer years will be beneficial to customers as well.

6 Dr. Johnson Testimony, Tr. at 1941. Customers also benefit from this provision because, at
7 the same time the new depreciation treatment begins, the Company's Systems Benefits
8 Charge will be reduced to reflect lower decommissioning trust funding obligations, thus
9 lowering customer rates. See Agreement at §§ 11.1, 11.4.

10 The Pension and OPEB cost deferrals are just as important. Allowing the Company
11 to record amounts prudently incurred above Test Year levels as a regulatory asset for
12 recovery in the next rate case takes an important step to improving the Company's financial
13 metrics without increasing the revenue requirement in the Agreement. See APS Exhibit 12
14 at 18; Guldner Testimony, Tr. at 1022; AIC Exhibit 1 at 5. As Staff Witness Elijah Abinah
15 explained, the expense deferrals are appropriate from a policy perspective to assist the
16 Company in reaching its required revenue level without having an impact on customers in
17 this rate case, even though those costs will eventually be collected from customers in the
18 future. See Abinah Testimony, Tr. at 1836.

19 Given the volume of discussion that took place during the hearing related to the
20 Schedule 3, APS will address both the significance to the Company of the proposed revenue
21 treatment of Schedule 3 proceeds and the Agreement's continuation of the Commission's
22 current policy in the following separate section.

23 **D. The Agreement's Provisions Relating to Schedule 3 are Material to the**
24 **Agreement and Benefit Customers.**

25 **1. Structure of Schedule 3**

26 *"In my opinion, the current Schedule 3 approach as modified by the agreement,*
27 *which assigns to new customers the direct cost of extending service to their*
28 *premises, but which does not include an additional impact fee, strikes the correct*
balance between fair considerations of the interest of new customers and
existing customers."

1 - Higgins Testimony, Tr. at 242.

2 In Decision No. 69663 (June 28, 2007), the Commission determined that new
3 applicants for service and applicants for upgraded service should be assessed the full cost
4 of that extension or upgrade. See Decision No. 69663 at 97 and 156. The Company's
5 Schedule 3 covers, among other things, service extensions and upgrades.² The current
6 version of Schedule 3, referred to throughout the hearing as Version 10, was approved by
7 the Commission in Decision No. 70185 (February 27, 2008). Since then, the Commission
8 enacted similar policies in the cases of UniSource Electric Company [Decision No. 70360
9 (May 27, 2008)], Tucson Electric Power Company [Decision No. 70628 (December 1,
10 2008)], Trico Electric Cooperative [Decision No. 71230 (August 6, 2009)], and Sulphur
11 Springs Electric Cooperative [Decision No. 71274 (September 8, 2009)].

12 The Agreement does not change the fundamental philosophy of the policy adopted
13 by the Commission in Decision No. 69663 and these subsequent electric utility decisions.
14 See Agreement at § 10.3. And, importantly, it does not change the amount of money that
15 new service applicants will be required to pay pursuant to that policy.³ As APS Witness
16 Jeff Guldner testified,

17 The other thing we, from a framework standpoint, felt that we were
18 accomplishing with the Schedule 3 provisions is we were able to [finance
19 the stay out] without . . . changing the current Commission policy on the
20 proceeds that were collected. In other words, we weren't imposing a new
21 cost on a class of customers. We were essentially taking a cost that was
already being paid and using it in different manners through the revenue
treatment

22 Guldner Testimony, Tr. at 618.

23 _____
24 ² Schedule 3 also addresses conversion of overhead to underground service, service relocation, and
25 temporary service, but none of these situations was affected by Decision No. 69663 as the Company has
26 always been fully reimbursed for conversions, relocations, and temporary service, even under prior versions
of Schedule 3. Moreover, under the proposal in this proceeding, APS would continue to record payments
from customers/public authorities for conversions, relocations, and temporary service as contributions-in-
aid. See Rumolo Testimony, Tr. at 2105-2016.

27 ³ Because the Agreement also requires a uniform and standardized set of charges for various components of
28 service extensions and upgrades, there would be minor impacts, both positive and otherwise, on individual
service applicants, as is always the case when all are charged based on average costs rather than specific
project costs.

1 In other words, new service applicants will pay the same amount of money for their
2 line extension or upgrade regardless of whether or not those proceeds are treated as
3 revenue for APS's accounting purposes. *Id.* For the Settling Parties, however, the revenue
4 treatment of Schedule 3 proceeds represents a considerable compromise compared to what
5 APS sought in its original application. In that application, APS proposed to include what
6 are termed "System Facilities" within the scope of Schedule 3 – a proposal that would have
7 added another \$6.6 million to \$12 million to the costs collected from new service
8 applicants. *See* Rumolo Testimony, Tr. at 662. APS also proposed a one-time impact fee
9 to be collected in addition to the Schedule 3 payments. The proposed impact fee would
10 have averaged about \$1500 per customer for residential applicants and a significantly
11 higher amount for commercial and industrial customers. Although it is unlikely that these
12 impact fees would have produced the \$53 million originally anticipated by APS before the
13 collapse in the real estate market, the impact fee would still have been a significant
14 increase in the costs new service applicants would have been required to pay for
15 connection. *Id.*

16 The Agreement required APS to withdraw each of these two proposals,
17 compromising instead on the revenue treatment of Schedule 3 proceeds. *See* Agreement at
18 §§ 10.5 and 10.6; Higgins Testimony, Tr. at 244. Other Settling Parties agreed that the
19 final terms of the Agreement represent a "balanced approach" to the issue of who pays for
20 service extensions and upgrades and in what amount:

21 I point out that while I believe it is just and reasonable for new customers
22 to be responsible for the direct costs of line extensions to reach their
23 premises, I'm not adverse to the concerns of new customers; rather, I
support a balanced approach.

24 In APS's initial filing the company proposed even greater fees for new
25 customers to recover incremental distribution system costs. In my direct
26 testimony I opposed that concept arguing that such an approach raises
27 many policy and economic questions and can result in unintended
28 consequences. And as part of the settlement agreement APS's proposed
impact fees are withdrawn.

1 Further, the agreement proposes some improvement to Schedule 3 terms
2 that are beneficial to new customers, which I fully support.

3 In my opinion, the current Schedule 3 approach as modified by the
4 agreement, which assigns to new customers the direct cost of extending
5 service to their premises, but which does not include an additional impact
6 fee, strikes the correct balance between fair considerations of the interest of
7 new customers and existing customers.

8 Higgins Testimony, Tr. at 242; *see also* Higgins Testimony, Tr. at 264.

9 Although the Agreement does not change the Commission's current policy
10 regarding customer payments for line extensions and upgrades, it does require several
11 important modifications to Schedule 3 that directly respond to many of the complaints and
12 inquiries about it received both by the Commission and APS. *See* Agreement at § 10.7;
13 Higgins Testimony, Tr. at 242. For example, in response to concerns raised about a lack of
14 price transparency and price consistency in the current version of Schedule 3, the
15 Agreement requires that Schedule 3 be revised to include a schedule of charges and a
16 statement that quotes provided to customers will be itemized. *See* Agreement at §10.7. As
17 APS Witness Daniel Froetscher testified:

18 I believe it's fair to say that price transparency as it relates to the cost of
19 extending services was expressed in a number of venues, similarly price
20 consistency associated with the line extension costs.

21 Q. To the extent that one of the modifications proposed to the existing
22 Schedule 3 through the settlement agreement will provide for itemization
23 of costs, for a schedule of the costs and whatnot, do you believe that would
24 add to, o[r], at least contribute to alleviating some of the concerns that have
25 been expressed on those points?

26 A. I do.

27 Hearing Testimony of APS Witness Daniel Froetscher ("Froetscher Testimony"), Tr. at
28 526, 650.

The schedule of charges will not only provide price transparency to the service

1 applicant, it will also provide the Commission with direct control over how much such
2 service applicants will be assessed for new or upgraded service. A schedule of charges
3 makes the provisions of Section 10.7 relative to written estimates customer-friendly in that
4 the potential service applicant can easily compare the written quote to the published
5 schedule of charges.

6 The absence of any refund provision was also a commonly cited complaint
7 concerning Version 10 of Schedule 3. *See* Guldner Testimony, Tr. at 655. The Agreement
8 responded to this concern as well, requiring Schedule 3 to be modified to permit potential
9 refunds under specified circumstances. *See* Agreement at § 10.7. By virtue of this
10 provision, the first applicant for service is allowed a means of recouping a portion of his or
11 her Schedule 3 assessment from a subsequent applicant who is directly connected to the
12 same distribution facilities. Along with the schedule of charges, the provision of itemized
13 quotes, and the abandonment the additional charges for System Facilities and impact fees,
14 the addition of a refund provision demonstrates that the Settling Parties responded to the
15 concerns expressed by potential and actual electric service applicants and attempted to
16 forge a compromise that would not unduly burden existing APS customers during these
17 trying economic times.

18 Another commonly raised issue was whether APS should allow third-party
19 contractors to construct all or a portion of a line extension, with the resulting facilities
20 being thereafter owned and maintained by APS. In that regard, the Agreement confirms a
21 service applicant's already existing ability to provide non-electrical work such as
22 trenching, conduit, and backfill. *See* Agreement at § 10.7. And, as indicated in the
23 testimony of APS Witness Daniel Froetscher, the Company has on occasion allowed the
24 use of third-party selected contractors to complete electrical work associated with service
25 extensions and is not necessarily opposed to expanding that use. *See* Froetscher
26 Testimony, Tr. at 756, 757, 758 and 759.

27 However, for the many reasons discussed by APS Witness Daniel Froetscher at
28 pages 532 through 540 of the hearing transcript, the Company recommends that the

1 Commission schedule one or more workshops on this subject to determine the parameters
2 and conditions for such third-party construction. This way, the Commission can hear from
3 other Arizona utilities and hopefully from utilities from jurisdictions that allow this
4 practice on a routine basis to determine both the potential advantages and any unforeseen
5 pitfalls. *See* Guldner Testimony, Tr. at 657-658.

6 **2. Revenue Treatment and Revenue Neutrality**

7 *"The revenue that APS projects it would collect under Schedule 3 is a critical*
8 *component of the settlement agreement, and the settlement agreement must be*
9 *viewed as an integrated document."*

10 - Smith Testimony, Tr. at 423.

11 As a general proposition the Agreement permits each Settling Party to determine for
12 itself what individual provisions of the agreement are "material." *See* Agreement at § 23.5.
13 The singular exception is the structure and revenue treatment of Schedule 3, which the
14 Settling parties specifically deemed to be "material to this Agreement." *See* Agreement at
15 § 10.2. That is why the Settling Parties agreed that any changes to Schedule 3 or to the
16 revenue treatment of Schedule 3 proceeds would need to be "revenue neutral to the
17 provisions of this Agreement." *See* Agreement at § 10.3.

18 The testimony of witness after witness made it clear precisely what was meant by
19 "revenue neutral." AECC Witness Kevin Higgins testified:

20 If the Schedule 3 proceeds are reduced through the adoption of a free-
21 footage allowance, then the agreement provides that the shortfall should be
22 made up through a bigger rate increase than is already provided in the
23 agreement.

24 Higgins Testimony, Tr. at 241.

25 The rate increase that would have been on the table, in my opinion, would
26 have been higher by the amount of the dollars that are projected for line
27 extensions that would have otherwise qualified for the footage.

28 Q. (Chairman Mayes) Why is that? If you could just lay it out in
simple terms for it?

1 A. Because, as I said earlier, I believe every nickel got squeezed out of
2 this deal. And I think that the rate increase that is in the settlement is really
3 the lowest reasonable rate increase that we could have achieved through
negotiation.

4 Higgins Testimony, Tr. at 296-297.

5 Staff Witness Smith agreed at several places in his hearing testimony:

6 The revenue that APS projects it would collect under Schedule 3 is a
7 critical component of the settlement agreement, and the settlement
8 agreement must be viewed as an integrated document.

9 Smith Testimony, Tr. at 423.

10
11 And Paragraph 10.3 of the settlement agreement provides that if such a
12 change were to be instituted by the Commission, an offsetting revenue
13 change should also be ordered so that such modifications would be revenue
14 neutral. Consequently, under this provision of the settlement agreement,
reinstating the free footage allowance would mean a higher rate increase
for APS's existing customers.

15 Smith Testimony, Tr. at 423-424.

16
17
18 Q. Mr. Smith, there was some discussion of consequences of treating
19 Schedule 3 as revenue. Let me ask you about consequences of not treating
20 Schedule 3 as revenue. Is it clear, Mr. Smith, that under terms of the
21 agreement that the treatment of Schedule 3 is considered a material
component of the settlement?

22 A. That is clear. I believe it's even spelled out in the settlement
23 agreement in one of the paragraphs under Section 10.

24 Q. And lastly, Mr. Smith, is it also clear that it's the -- at least the
25 agreement of the parties, that any alteration of that treatment of Schedule 3
should be done in a manner that is revenue neutral to the agreement?

26 A. Yes. That is provided for in section -- in paragraph 10.3.
27
28

1 Q. And just so there is no mistake as to the term revenue neutral, it
2 essentially means that dollars that disappear from the Schedule 3 treatment
3 have to appear someplace else?

4 A. That is my understanding of what was meant by revenue neutral in
5 the context of paragraph 10.3.

6 Smith Testimony, Tr. at 1793-1794.

7 So did RUCO Witness Jerich:

8 If the Commission were to return to some free footage allowance, it must
9 be revenue neutral. If it is the decision of the Commission to reinstitute free
10 footage for residential landowners, RUCO urges the Commission to find a
11 compromise that shifts as little of the burden to the rest of the ratepayers as
12 possible.

13 Jerich Testimony, Tr. at 903-904.

14 Treatment of Schedule 3 proceeds as revenue is a material provision of the
15 settlement agreement. APS estimates Schedule 3 revenues to be 23 million
16 in 2010, 25 million in 2011, and 49 million in 2012. These sums were a
17 significant consideration in reaching an agreement on the revenue
18 requirement and overall magnitude of the rate increase. Without this
19 treatment of Schedule 3 proceeds, there was very little chance that the
20 parties could have come to a mutually acceptable agreement on the size of
21 the revenue increase.

22 To further complicate the consideration of altering the existing line policy,
23 Section 10 of the settlement agreement is directly linked to Section 2.
24 Section 2 prevents new base rates until at least July 1, 2012. Section 2 is
25 particularly important to RUCO.

26 Without sufficient revenues in years 2010, 2011, and 2012, APS, in
27 RUCO's opinion, would not be able to stay out for two-and-a-half years
28 without another rate case application. After a continuous string of rate
cases, RUCO believes that the ratepayer deserves a break from increasing
utility bills.

Jerich Testimony, Tr. at 906.

As the foregoing makes clear, the revenue treatment of Schedule 3 proceeds
proposed in Section 10 has at least two clear benefits: (1) it directly reduces the size of the

1 base rate increase needed from existing APS customers in this case; and (2) it enables the
2 Company to agree to a “stay out” of two-and-a-half years and abide by the other terms of
3 the rate case schedule called for in Sections 2.1 through 2.5 of the Agreement. *See* Guldner
4 Testimony, Tr. at 617-618; Hatfield Testimony, Tr. at 2493.

5 Neither does the revenue treatment of Schedule 3 proceeds require customers to pay
6 for the same asset twice. The general objection to including what some may characterize,
7 incorrectly, as “customer-funded assets” in rate base is that customers end up paying twice
8 for the facilities: once at the outset and then again through base rates. That is simply **not**
9 the case here. First, although new service applicants pay a fee equal to the estimated cost of
10 the facilities upfront, they are not required to pay for those assets again through rates
11 because **the identical amount of revenue from customers reduced dollar-for-dollar the**
12 **revenue requirement that was necessary for APS to agree to the settlement.** *See*
13 Hatfield Testimony, Tr. at 2401-02; Higgins Testimony, Tr. at 246-47. The base rates
14 ultimately charged to customers are thus **NOT** the same as they would have been had APS
15 not received any funds from the applicant – they will be significantly lower, for at least the
16 term of this Agreement and likely for decades beyond. *See* Hatfield Testimony, Tr. at
17 2402; Higgins Testimony, Tr. at 247-48 (testifying that the revenue treatment is not a
18 “double-dip”).

19 Moreover, as proposed, Schedule 3 proceeds should not be characterized as
20 customer-donated capital. Customers do not pay the actual cost of the facilities, but the
21 estimated cost of the extension pursuant to a pre-established schedule of charges. *See*
22 Agreement at § 10.7; Hatfield Testimony, Tr. at 2402; Rumolo Testimony, Tr. at 2243. In
23 this regard, the revenue treatment of Schedule 3 proceeds is not so much an issue of
24 “customer donated capital” as one of cost-allocation – requiring new applicants for a line
25 extension to pay for a greater portion of the cost of service thus keeping base rates paid by
26 **all** customers significantly lower. *See* Hatfield Testimony, Tr. at 2402-03. In the end, all
27 customers benefit, without requiring line extension applicants to pay a penny more for
28 connection than they would without the revenue treatment. *Id.*

1 In addition, the classification of certain (but not all) proceeds from Schedule 3 as
2 revenue is clearly within the Commission's authority. Indeed, the entire distinction
3 between contributions in aid of construction ("CIAC") and revenue is the product of
4 regulatory fiat rather than some overarching economic, legal, or accounting principle. *See*
5 Rumolo Testimony, Tr. at 894. And although the Commission previously declined to adopt
6 this accounting change in Decision No. 70185, that decision was based at least in part on
7 the fact that the Commission had been asked to make the change as part of a compliance
8 filing and not in the context of establishing rates and charges through a general rate case.
9 *See* Decision No. 70185. As a result, there would not be the immediate benefit to
10 customers such as is presented by terms of the Agreement. Clearly, that is not the case in
11 this rate proceeding.

12 Finally, by the Agreement's terms, the revenue treatment discontinues at the earlier
13 of either December 31, 2012 or the conclusion of the Company's next general rate case.
14 *See* Agreement at § 10.1. After that point, the Company will be required to record new
15 Schedule 3 proceeds as CIAC, unless ordered otherwise by the Commission. *Id.* The
16 Settling Parties intentionally limited the timing of the revenue treatment to until the
17 Company's next rate filing, believing the intervening period to be "an opportunity to
18 continue to pursue the issue and look at the policy and decide what's the best thing to do on
19 a long-term basis before we get to that rate case." Guldner Testimony, Tr. at 619. With
20 some data under its belt, the Commission can determine a few years down the line whether
21 the revenue treatment should be continued. *See Id.*

22 And although there has been some concern that, in the long-term, the revenue
23 treatment is less beneficial to customers than recording Schedule 3 proceeds as CIAC, there
24 is no dispute that the base rate benefit to customers from the revenue treatment is
25 significantly greater during this 2010 to 2012 "test" period (the first time in which the
26 Company is permitted to file its next rate case). *See* Higgins Testimony, Tr. at 247 ("From
27 a customer point of view, in the short run it is a larger rate benefit to recognize the
28 contributions as revenue. So there is an attractiveness of that from the perspective of

1 today.”). In fact, as previously discussed, the Settling Parties would not likely have reached
2 agreement on the base rate revenue requirement at all absent this Schedule 3 provision.
3 Going forward, by not recording Schedule 3 proceeds as CIAC during 2010-2012, the
4 Company’s rate base in future proceedings will be higher by the sum of the proceeds, net of
5 tax, treated as revenue. Even so, that result will increase revenue requirements in the next
6 case by significantly less than 1%, even assuming the Commission does not continue
7 revenue treatment in the Company’s next general rate proceeding. *See* APS Late-Filed
8 Exhibit 39 at 111. The Settling Parties believed, and the record in this proceeding
9 demonstrated, that reducing the base rate increase in this proceeding and the overall present
10 value benefit to APS customers more than offset this potential for higher future revenue
11 requirements in 2012, when hopefully the economy has recovered. *See* Guldner Testimony,
12 Tr. at 763, 767, 770, 771; *see also*, APS Exhibit 27.

13 To the extent the Commission does wish to consider some modifications of Version
14 10 of Schedule 3, the Company prepared several exhibits displaying the dollar impact.
15 These range from a complete return to Version 8 of Schedule 3 to very modest equipment
16 allowances for limited types of line extensions. *See* APS Exhibits 17 and 26; Rumolo
17 Testimony, Tr. at 2240.

18 **III. CALCULATION OF THE INCREASE AND IMPACT OF THE** 19 **ACCOUNTING MECHANISMS IN THE AGREEMENT**

20 The Settling Parties did not spell out the specific mechanics of calculating a “bottom
21 up” revenue requirement. The primary focus, instead, was on balancing the desire to reduce
22 the level of any base rate increase with APS’s need for enhanced financial stability. For
23 that reason, the numbers expressed in the Agreement reflect a straightforward approach of
24 establishing the legally required rate base and determining the rate of return. Nevertheless,
25 the record is more than sufficient to calculate each of the ratemaking components needed to
26 produce the base rate increase set forth in Section 3.8 of the Agreement, as the following
27 shows in attempt to clarify some issues on this subject raised during the hearing.
28

1 The historical period used by the Agreement to determine operating income, rate
2 base and rate of return was an adjusted 2007 test year. See Agreement at § 3.5. The
3 original cost rate base (“OCRB”) of \$5,582,135,000 and the fair value rate base (“FVRB”)
4 of \$7,665,727,000 come directly from Attachment A to the Agreement. Although
5 reconstruction cost new rate base (“RCNRB”) is not listed on Attachment A or identified in
6 the Agreement, it is derived mathematically from the equation $[(OCRB + RCNRB) \div 2 =$
7 $FVRB]$ or $[RCNRB = (2 \times FVRB) - OCRB]$. In this case, pursuant to that calculation,
8 RCNRB is \$9,749,319,000.

9 There also was some discussion during the hearing as to the total revenue
10 requirement and the total base rate revenue requirement, and whether there was any
11 difference between the two. As shown in the Agreement at Section 3.8, base rate revenues
12 for the adjusted test year were \$2,637,447,000. Including the Other Electric Operating
13 Revenues of \$94,965,000, see Smith Testimony, Tr. at 1738, this produces total adjusted
14 test year jurisdictional revenues of \$2,732,412,000. The total base rate revenue increase
15 called for under the Agreement is \$344,738,000 (inclusive of the interim rate surcharge and
16 the increase in base fuel). See Agreement at §§ 3.1, 3.2, and 3.6.

17 The Settling Parties did not consider the proposed accounting treatment of Schedule
18 3 proceeds starting in 2010 as a component of either adjusted year revenues or the revenue
19 requirement used to establish base rates. It was just one of several accounting provisions
20 established by the Agreement and is, in that respect, no different than the deferral of certain
21 pension costs and the reset of the Palo Verde depreciation rate – neither of which could be
22 argued as contributing to adjusted test year revenues.

23 There is recent precedent for the position taken by the Settling Parties. For
24 example, both of the Company’s last two rate decisions authorized cost deferrals. In
25 Decision No. 67744 (April 7, 2005), it was vegetation management (bark beetle) expense,
26 while Decision No. 69663 permitted deferrals of unrecovered fixed costs, as defined
27 therein, associated with the Company’s net metering pilot program. Similar to the
28 approach taken in the Agreement, these accounting authorizations did not impact adjusted

1 test year base rate revenue requirements in either Decision No. 67744 or 69663.

2 As discussed previously, each of the accounting provisions in the Agreement was
3 essential to maintaining the Company's financial condition through 2012 and supported the
4 Rate Case Filing Plan called for in Sections 2.1 – 2.5 of the Agreement. In the absence of
5 these provisions, the base rate increase agreed to by APS would have had to have been
6 substantially larger. See APS Late-Filed Exhibit 39 at 111.

7 In conclusion, one can find directly in the record, or mathematically calculate from
8 numbers in the record, each of the following: OCRB, RCNRB, FVRB, rate of return on
9 FVRB, adjusted test year base rate revenues, total adjusted test year revenues, and the total
10 annual adjusted test year revenues needed to produce the increase in base rates stated in
11 Section 3.8 of the Agreement. Neither Schedule 3 nor the other accounting provisions of
12 the Agreement impact any of the above amounts excepting to the extent they permitted
13 APS to agree to a smaller base rate increase, as well as to the Rate Case Filing Plan.

14 **IV. LEGAL CONSIDERATIONS PERTAINING TO SUGGESTIONS RAISED**
15 **DURING THE PROCEEDINGS**

16 Every rate case before this Commission involves the fundamental legal issues of
17 establishing just and reasonable rates, as well as the utility's constitutional right to a
18 reasonable opportunity to earn a fair return on its rate base. In this proceeding, additional
19 issues were raised and warranted being separately briefed.

20 **A. Fair Value.**

21 Some of the questioning during the hearing appeared to suggest that the Company's
22 rate base should either be explicitly based solely on OCRB or, perhaps alternatively, that
23 the FVRB be deemed to be equal to original cost. Either course of action takes an
24 unnecessary risk of making the Commission's final decision subject to attack on
25 constitutional grounds.

26 The requirement that rates for Arizona public service corporations be established on
27 FVRB was clearly articulated by the Arizona Supreme Court in *Simms v. Round Valley*
28 *Light & Power Co.*, 80 Ariz. 145, 294 P.2d 378 (1956). Moreover, the *Simms* court

1 explicitly rejected the contention that FVRB could be equated to original cost:

2 It is clear, therefore, that under our constitution as interpreted by this court,
3 the commission is required to find the fair value of the company's property
4 and use such find as a rate base for the purpose of calculating what are just
5 and reasonable rates.

6 [3] The commission argues that fair value as used in the constitution may
7 be considered as synonymous with prudent investment. This theory we
8 cannot approve.

9 *Simms*, 80 Ariz. at 151; 294 P.2d at 382.

10 Although now over 50 years old, the *Simms* decision has not been reversed or even
11 modified by subsequent courts. Indeed, it has been applied even in the case of competitive
12 services. *U.S. West Communications, Inc. v. Arizona Corp. Comm'n*, 201 Ariz. 242, 34
13 P.3d 351 (2001) (Although not the exclusive basis for setting competitive prices, FVRB
14 must still be considered by the Commission in such circumstances). Even more recently,
15 the Court of Appeals emphasized that the Commission must not only ascertain FVRB but
16 must also attribute some level of return to what has been called in this and other
17 proceedings the "fair value increment."⁴ The fair value increment is the difference
18 between OCRB and FVRB. If FVRB were to be equated with OCRB, there would be no
19 fair value increment, thus effectively evading the court's holding in *Chaparral City Water*
20 *Co.*

21 A failure to find FVRB when one is required is arguably a jurisdictional defect to
22 the Commission's order. That means that not only can parties to this docket challenge it on
23 direct appeal, it might be collaterally attacked even in circumstances when A.R.S. §40-252
24 would otherwise appear to prohibit such actions. *Scates v. Arizona Corp. Comm'n*, 118
25 Ariz. 531, 578 P.2d 612 (Ariz. App. Div. 1 1978); see also *Mountain States Tele & Tele*
26 *Co. v. Arizona Corp. Comm'n*, 604 P.2d 1144, 1146-48 (Ariz. App. Div. 1 1979).

27 _____
28 ⁴ Although only a memorandum decision legally binding the Commission solely in that rate case, the Commission should not be unmindful of the Court's opinion.

1 The benefits of the instant Agreement are too important to potentially gamble away
2 in an attempt to make Arizona regulatory decisions read like those of other jurisdictions.
3 Arizona is different from those other states, and its position on FVRB, although clearly in
4 an increasingly small minority of regulatory jurisdictions, has been clearly and repeatedly
5 articulated by our courts. APS would urge the Commission not to take such a gamble.
6 This is especially so when the experts in this case uniformly testified that such cosmetics
7 would not affect investor perceptions. See Higgins Testimony, Tr. at 349; Dr. Johnson
8 Testimony, Tr. at 2006-2007; Hatfield Testimony, Tr. at 2508. As Staff Witness Ralph
9 Smith succinctly testified:

10 I wouldn't want to see the settlement agreement or the rates adopted in this
11 case jeopardized by an amendment that could call into question whether the
12 Commission has adequately considered and used the fair value rate base
that's supported by an abundance of evidence in this case.

13 In other words, I don't think you can just substitute an original cost rate
14 base for fair value rate base. That would be -- I would be a bit concerned
15 about that potentially jeopardizing the resulting result in terms of meeting
the constitutional requirement to consider fair value.

16 Smith Testimony, Tr. at 1734; see also Yaquinto Testimony, Tr. at 2270.

17 **B. Unbundled Billing**

18 At pages 2585 and 2586 of the hearing transcript, Judge Farmer requested that the
19 Settling Parties brief the issue of whether unbundled billing was still required by
20 Commission order or rule. Judge Farmer further made it clear that she was not questioning
21 the requirement for unbundled rates but merely whether such unbundled charges need be
22 presented on the customer's bill.

23 The Commission rules requiring unbundled billing are A.A.C. R14-2-1612(O)
24 ("Rule 1612") and A.A.C. R14-2-210(B)(k) ("Rule 210"). Although Rule 1612 (a part of
25 the Commission's "Competition Rules," A.A.C. R14-2-1601, *et seq.*) has been expressly
26
27
28

1 ruled to be legally invalid, Rule 210 has not. In the *Phelps Dodge* decision,⁵ the Court of
2 Appeals invalidated a number (but not all) of the Commission regulations commonly
3 referred to as the “Competition Rules.” Some Competition Rules were found to be
4 unconstitutional, while others were stricken down for non-compliance with the provisions
5 of the Arizona Administrative Procedures Act – specifically, for lack of certification by the
6 Attorney General of Arizona. Rule 1612 was in that latter group. To APS’s knowledge,
7 the Commission has never requested that the Attorney General certify Rule 1612 and it
8 thus remains ineffective under *Phelps Dodge*.

9 On the other hand, although the relevant portions of Rule 210 were enacted at the
10 same time and by the same Commission order as was Rule 1612, it was not challenged in
11 the *Phelps Dodge* case. Thus, although the amendments to Rule 210 that require
12 unbundled billing also were not certified by the Attorney General and thus may be legally
13 suspect after *Phelps Dodge*, they have not been invalidated by any court. For that reason,
14 to be cautious, APS’s compliance with Rule 210 would likely need to be waived by the
15 Commission for APS to stop issuing unbundled billings.

16 V. CONCLUSION

17 ***“The Corporation Commissioners will consider the settlement in the months ahead.
18 While they’ll want to look closely at such a complex package, they’ll find strong reasons
19 to approve it.”***

20 - Paper Position Editorial, “*Unusual Unity on Rate Increase Good for
21 State*,” **THE ARIZONA REPUBLIC**, August 30, 2009.

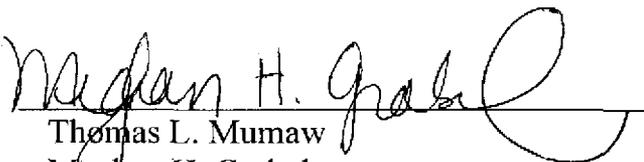
22 The Agreement presented to the Commission marks a sustainable path toward
23 Arizona’s energy future. It promotes environmental stewardship by requiring unparalleled
24 energy efficiency measures and considerable investments in renewable energy. It protects
25 Arizonans on limited incomes from increasing electric bills during difficult economic
26 times. It creates hundreds of new “green” jobs for the State of Arizona. By bringing
27 electric prices closer to the true cost of electricity, it sends proper price signals to

28 ⁵ *Phelps Dodge Corp. v. Arizona Elec. Power Coop., Inc.*, 207 Ariz. 95, 83 P.3d 573 (Ariz. App. Div. 1
2004), review denied (2005).

1 customers, encouraging them to take advantage of the robust energy efficiency programs
2 the Agreement provides. And it significantly enhances the financial condition of Arizona's
3 largest utility, thus enabling the Company to continue to provide reliable electric service
4 and promote the energy future the Agreement envisions. **All this for less than a one**
5 **percent net increase in average annual residential customer bills** – a key benefit to
6 customers in these difficult economic times.

7 It is no wonder that this Agreement is supported by so many. Twenty-two parties,
8 representing stakeholders ranging from customers of all types (residential, commercial,
9 industrial, and public agencies) to environmental advocates to union workers to utility
10 investors have found that this Agreement, when taken as a cohesive package, supports the
11 public interest. APS urges the Commission to do the same and approve the Agreement.

12 RESPECTFULLY SUBMITTED this 9th day of October, 2009.

13
14 By: 
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16 Meghan H. Grabel

17 Attorneys for Arizona Public Service Company

18 ORIGINAL and thirteen (13) copies
19 of the foregoing filed this 9th day of
20 October, 2009, with:

21 Docket Control
22 ARIZONA CORPORATION COMMISSION
23 1200 West Washington Street
24 Phoenix, Arizona 85007

25 AND copies of the foregoing mailed, hand-delivered,
26 faxed or transmitted electronically this 9th day of
27 October, 2009 to:

28 All Parties of Record



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