BEFORE THE ARIZONA CORPORATION COMMISSION

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 PERMANENT EVIDENTIARY HEARING

At: Phoenix, Arizona

Date: September 14, 2009

Filed: September 15, 2009

REPORTER'S TRANSCRIPT OF PROCEEDINGS

VOLUME IX
(Pages 1849 through 2092, inclusive.)

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Court Reporting
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BE IT REMEMBERED that the above-entitled and numbered matter came on regularly to be heard before the Arizona Corporation Commission, in Hearing Room 1 of said Commission, 1200 West Washington Street, Phoenix, Arizona, commencing at 9:36 a.m. on the 14th of September, 2009.

BEFORE: LYN A. FARMER, Chief Administrative Law Judge

Note: No roll call taken. The following is a list of the parties of record.

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CALJ FARMER: Good morning. Welcome to the Commission. Before we start with testimony let me see if there are any procedural matters that we need to talk about.

Mr. Robertson.

MR. ROBERTSON: Your Honor, I wouldn't characterize it as an issue but it is a matter. I learned Friday afternoon after I left the hearing that a conference call has been scheduled at 11:00 this morning in which I have to participate. I do have some cross-examination for Dr. Johnson.

I am not sure when we will be getting to him today, but should you arrive at what would be my turn to cross-examine him while I am absent from the hearing room, with your permission, Mr. Crockett has very graciously agreed to pose my questions for me and Mr. Pozefsky has indicated he would have no objection to that. As has been my practice with the APS and the Commission Staff witnesses where I have had cross-examination, I provided Mr. Pozefsky last Friday with a list of the questions I would be posing Dr. Johnson and I believe Dr. Johnson has that list as well. So I would hope it would go rather smoothly.

But I wanted to present that to Your Honor beforehand. And in case you see me getting up and leaving the hearing room shortly before 11:00 this morning, that's the reason why. Thank you.

CALJ FARMER: Okay. Thank you very much.

Any other procedural issues or matters?

(No response.)

CALJ FARMER: Okay. I believe we are going to start with Ms. Pecora's witness. Is your witness ready?

MS. WYLLIE-PECORA: I am, Your Honor.

CALJ FARMER: Do you want to call your witness.

MS. WYLLIE-PECORA: Bobby Miller.

BOBBY MILLER,

a witness herein, having been first duly sworn by the Certified Reporter to speak the truth and nothing but the truth, was examined and testified as follows:

DIRECT EXAMINATION

Q. (BY MS. WYLLIE-PECORA) Okay. In front of you, Mr. Miller, is a testimony. Are you familiar with that testimony?

A. I am.

Q. Did you prepare that testimony?

A. Yes.

MS. WYLLIE-PECORA: Okay. And just for the record, his testimony, the one that we are talking about, was filed with my original testimony on July 22nd. But I have given it to the court reporter and it is P-12.

Q. (BY MS. WYLLIE-PECORA) Would you mind going ahead and reading that testimony for us.

A. In its entirety here?

Q. Please.

A. Please state your name and address and employer. Bobby Miller, answer is Bobby Miller, 22422 North 80th Lane, Peoria, Arizona.

MR. MUMAW: Your Honor, may I ask, is this really necessary to read what has already been prepared testimony?

CALJ FARMER: Ms. Pecora, it really is not. It is going to be entered as an exhibit as if he is actually saying the words. But maybe what you would like for him to do is summarize and ask if there is anything in this that he needs to change or if he is --

MS. WYLLIE-PECORA: Okay. Let's go that direction.

Q. (BY MS. WYLLIE-PECORA) Would you like to summarize it and add anything? If you want to, just skim through it and touch on what you want.

A. There were a number of different questions. I am not sure exactly where I would summarize each individual question because every one was so different. I believe we would probably do well to accept the testimony in. I feel comfortable that those answers are correct. And they were, they were correct at the time and they are still correct now.

I know that there was some responses directed to me from APS regarding those questions that may be more introspective into these matters that might make a difference. That would probably be something that would be more relevant than to go question by question on something we have already done.

But I will be glad to address any one of the issues or any or all of the issues as they are questioned to me.

MS. WYLLIE-PECORA: Okay. Well, and you can tell me how we should do that. APS did address a number of questions to Mr. Miller. And he did respond. Now, I don't know if that's part of the record or if he should go ahead and read those questions and answers.

CALJ FARMER: Okay. I am not sure, is this a document that he has prepared in response to some APS --

MS. WYLLIE-PECORA: APS first set of data requests to intervenor Barbara Wyllie regarding the testimony of Bobby Miller. And this was done

August 5th. They sent questions to me for Mr. Miller to answer. And he did that. So I was just going to see if we could put those in the record.

CALJ FARMER: Sure. That would be fine, because those aren't docketed. If that's part of your discovery, then I don't have copies of that and don't know what his responses were nor do I know what the questions were.

MS. WYLLIE-PECORA: Okay. Then I will read the questions and he can read the answers. I think there is only two or three.

THE WITNESS: Yes, they were just more clarification questions I believe on some of the issues that I had already given testimony to.

MS. WYLLIE-PECORA: And, in fact, I will just summarize it.

Q. (BY MS. WYLLIE-PECORA) One was please provide all documents associated with any such evidence, including any study or analysis in its original form. If electronic, please provide such document with all format intact.

And they were referring to the fact that in his original testimony he stated that this policy has afforded hundreds of thousands of property owners the opportunity to improve and occupy otherwise unimproved property.

And then the other question that they wanted, to prove that this particular policy had a positive effect over the years. If no study or analysis exists regarding this statement, please provide an explanation as to how Mr. Miller justifies his conclusion that the 1,000 foot free policy has afforded hundreds of thousands of property owners the opportunity to improve and occupy otherwise improved -- unimproved properties.

Okay. Your answer.

A. Well, it is already written here but I will respond by using my own words in the testimony that I responded with. It says:

My response stating hundreds of thousands of property owners have benefited from the thousand foot free policy comes from personal experience. I am the one who actually walks these properties, meets the prospective residents and watches the hopes and dreams of these prospective residents come to fruition or not.

Throughout the State of Arizona over the past 30 years I have personally sold well over a thousand individual properties which may -- many of which were located in rural areas where the property owners have benefited from this property -- policy. I apologize. Nearly all of these developed properties surrounding these parcels that I sold also benefited from this policy. In almost every case these property owners benefiting from the thousand foot free policy would otherwise not have developed these properties had the expensive utility extension been added to their improvement cost.

I know this to be true as I speak to these people. I hear their stories and listen to concerns. The property owners that today seek the opportunity to develop these parcels face the absence of this policy. The expense to develop with the added expense to extend and supply power has increased so dramatically that their improvement costs have become financially prohibitive and their hopes of improving these parcels have been dashed.

I have spent countless hours in my 30 plus years of land sales in the rural areas of Arizona, specifically Maricopa County, where I have personally witnessed untold numbers of properties developed into habitable residences and businesses utilizing the thousand foot free policy.

My figure of hundreds of thousands was not quantified with names and addresses; however, a simple aerial view of the greater Phoenix area should suffice in support of these numbers. Buckeye, Rainbow Valley, Arlington, Liberty, Palo Verde, Hassayampa, Wintersburg, Tonopah, Sun Valley, Waddell, Surprise, Wittmann, Whispering Ranch, Circle City, Morrison -- I am sorry -- Morristown, Wickenburg, North Peoria, Desert Hills, New River, Black Canyon City, Cave Creek, Carefree, and north Scottsdale alone could easily demonstrate the truth of these numbers. Yet they are only the north and west areas of the greater Phoenix area. The south and east could show approximately the same numbers. This is only speaking of the areas associated with the greater Phoenix valley. The number of other communities and areas benefiting from this policy in times past go far beyond the valley.

As a resident of the valley since 1951, my birth year, I have been personally, I have personally witnessed the development of these areas. I have also seen this development activity come to a near stop since the policy was discontinued. It is my opinion that it is not good for the property owners, the future of our economy, nor the growth and continued development of our power suppliers and their supply grids.

Q. Okay. And the second question was: On page 1 of the testimony, Bobby Miller, in response to the same question referenced in question APS 1.1 above, Mr. Miller states it made most rural development possible when it otherwise would financially be beyond the reach of 99 percent of today's property owners. Please provide any and all evidence that Mr. Miller relied upon to support this statement, including any study or analysis performed and the results thereof.

A. Obviously I didn't have a study or an analysis done, but in the response to the question:

My testimony regarding 99 percent of today's property owners wishing to develop their parcel was based upon my personal experience. I speak daily with property owners. I have heard the horror stories of families who have invested much of their life's savings to purchase property with the hopes of one day developing and moving onto these parcels be washed away by the flood of added expenses. In many cases the cost of utility extension and supply to a new residence is equal to or greater than the actual cost of the property itself. This dramatic increase in development expenses has caused many of these facilities to abandon -- many of these families to abandon any previous plans to relocate to their land parcel on a new residence.

Q. Okay. And then the last question on page 2 of the testimony of Bobby Miller, in response to the question could you see an adverse effect down the road due to the removal of this 1,000 foot free, Mr. Miller states there are literally hundreds of thousands of property owners directly affected by this policy change in an extremely negative way. Please provide any and all evidence that Mr. Miller relied upon in this statement, including any study or analysis performed with the results here.

A. My response was very clear. It says:

The county assessor's records clearly demonstrate a large number of properties that could be developed immediately that lie within a thousand feet of an existing power source. Every single property in this category is directly affected with a substantial additional expense to develop, many times making it financially prohibitive to proceed, due solely to added expense.

There is a domino effect from this policy change that reaches far into much of our local economy. Not only have families' hopes and dreams been dashed, but material suppliers, construction laborers, draftsmen and architects, engineers, equipment operators, real estate agents, mortgage brokers, insurance agents, service providers, manufactured home factories and installers, landscape agents, landscaping companies, and so many more from the private sector have been affected. Municipalities, counties, the State of Arizona have equally been affected as this vital sector of our economy discontinues to operate. Building inspections, plan reviews, flood control officers, engineering departments, planning and development divisions, engineering -- I am sorry -- environmental agencies, health departments, and many more have also been directly affected.

Many of the most devastating impacts of all -- maybe one of the most devastating impacts of all would be felt when these properties, once highly valued, begin to sell little to nothing and rural properties, along with state trust lands, experience the devaluation that will ripple well into our state, county and city's budgets, as they are sure to do. This has already begun.

I personally own rural property valued by the county assessor upwards of $30,000 that have seen nearby sales on comparable sized properties in recent months of $5,000. I believe this extreme reduction in price is more the result of the loss of the thousand foot free policy than our current economic conditions. I can assure you that a sweeping move will be afoot this coming tax year to reduce property valuations across the board using these fire sales as comparables when arguing property tax valuations. This is sure -- this will surely cause a reduction in much needed and depended upon revenues to our state treasury as well as local governments. The valuation on state trust lands will experience the same in my opinion, affecting the future of our state's economy.

In summary, I believe it is a crying shame that a single policy change could be so all encompassing. The good news, however, is that the return of this policy could have the effect of reversing much of these problems and the potential of providing a much needed boost to our economic condition that affects us all.

Q. Thank you. Now I just have a couple questions.

First of all, would you mind telling the court what your nickname is and how you got it.

A. My nickname is Dr. Dirt. I have been selling land for 32 years. And when I first went into the real estate business after leaving the construction industry, I went into a small real estate company called Unique Real Estate in the northwest Phoenix area. My first day in the business, I landed a client who was looking for property and I ended up ultimately, from that particular call, landing a 40-acre subdivision that was getting ready to be developed. And I started working in land from the first day I went into the business.

As time progressed, maybe about a year later into the business, the whole office was getting ready to go on their office tour. It actually started out as a negative connotation, if you will, but they were all getting ready to go on an office tour whereby they visit all their new residential listings each Tuesday or Wednesday morning, and I didn't go with them. And as they filed by my desk, somebody asked why doesn't he ever go on tour with us. And somebody just kind of tongue in cheek said because he thinks he is Dr. Dirt or something.

It was kind of a unique situation. And I didn't take it negatively too badly, but it was just a response.

The following day, I had two calls for a Dr. Dirt. They didn't know anything about what the gentleman's name was but they wanted to find out this land specialist because they had a specific need.

This was the late '70s and the market had started to pick up and people wanted to find out an opportunity to purchase land, and they wanted to know who this Dr. Dirt guy was.

As a result, this has been a name that stuck. We since registered with the state Corporation Commission, I mean with the Secretary of State's office. And I have had to protect that name a number of times because of infringement. It is one of those things that seemed to work out. And it is on my business card. It is on my website. And it is, it is who I am now.

Q. Good. Interesting.

Okay. There has been a lot of talk during this procedure about the number of vacant homes within the metropolitan areas due to foreclosures. Testimony by some of the residents, or some of the experts, have said that having the present Schedule 3 policy in place, these people who would otherwise move to rural areas should purchase vacant homes in the metropolitan areas that already have electrical service.

My question to you is: In your experience in working with individuals seeking a rural lifestyle, would these people now purchase the existing vacant homes in cities? And if not, why not?

A. Well, that's a unique question, could probably have a lot of different responses. From my initial point of view, I would say that the people who want to live in rural Arizona are a different mind-set than those that want to live in the center city. A lot of the vacant homes are available, and we are all aware of them, but the same issues face those people trying to get into those homes as the ones trying to save those homes. We have current economic conditions that are facing us that are unique and loom over our whole industry.

But the mind-set, I think, of those who wish to rurally move their lifestyle are those that I don't believe would adapt well back to the city. I think a lot of people kind of want to get away from it all.

That's the great thing about Arizona. We have a lot of open space, a lot of open areas. There are people who have set their entire lifestyle based upon equestrian operations, the ownership of animals or the opportunity to spread out, maybe to escape homeowner's associations which in many instances are so ridiculously punitive that there are people who won't go into certain communities. I have sold a number of lots over the years based on the issue where people just wanted to get away from an HOA, get me out of an HOA.

And I think that that could be a reasonable argument to say go use up these vacant homes within the valley. I don't think there will ever be a shortage of opportunities within the valley. Our biggest issue is being able to establish a lifestyle and maintain a lifestyle that these people are looking to create. And that lifestyle many times is to be in rural Arizona.

Q. Okay. Thank you. Are you aware of people who may have lost their land or let it go back to the lenders because of this new policy, that maybe they weren't aware of the change in Schedule 3?

A. Well, I will answer that question twofold. First, no, I am not aware specifically of anyone who lost their land as a result, direct result of this policy only. Second, I will say that I have probably sold, like I said, I have sold well over a thousand individual transactions, individual parcels of property, and I would, I would venture to say from the discussions that I have had with the people that I have sold property to that at this point in time I don't believe 5 percent of the people who own land in rural Arizona are aware that they have had this policy changed. It is going to be an extreme wakeup call when they make their phone call to get their thousand foot free power which they were quoted at the time they bought their property, five or seven years ago.

Q. You say 5, you think only 5 percent --

A. 5 percent of --

Q. -- of the people are aware?

A. Are aware of this policy change. I don't think people know about this policy change.

Q. Wow, okay. Do you know of any builders who are not developing land?

A. Well, there are a number of manufactured home builders, manufactured home manufacturers who have been all but shut down as a result of rural Arizona not being able to develop. They can't do what they used to do. They used to build homes, buy a lot, set it on the site, set up financing packages available so John Q home buyers could move themselves out to rural Arizona. That's not an option to many of these individuals now because of the cost of the extension of power.

Q. Okay. From a Realtor's perspective, what do you think of the current proposed refund policy on the proposed Schedule 3? Are you familiar with it?

A. I read it. I don't think that it -- it is far less than a Band-Aid on the problem, or on the situation. I believe that, from my point of view, it is not something that would benefit the buyers and sellers at all as the previous policy did. And I think it is a Band-Aid at best.

MS. WYLLIE-PECORA: Okay. For now that's all my questions, Your Honor.

CALJ FARMER: Do you want to go ahead and move the admission of his testimony, that Exhibit 12?

MS. WYLLIE-PECORA: I will move that we admit Exhibit 12 testimony.

CALJ FARMER: Thank you. That was prefiled and no objections have been received, so it will be admitted.

(Exhibit No. P-12 was admitted into evidence.)

CALJ FARMER: The parties who have questions for this witness? Okay. Let's start with APS and then we will move over this way.

APS.

MR. MUMAW: Thank you, Your Honor.

CROSS-EXAMINATION

Q. (BY MR. MUMAW) Good morning, Mr. Miller.

A. Good morning.

Q. We talked about the nickname Dr. Dirt. You indicated that use it in your advertisements and so forth. Would I be correct that that's also on your license plate, that admittedly very nice Corvette in the parking lot?

A. Yes. That is --

Q. Nice car.

A. It is a nice car. By the way, it is for sale as a result of the lack of sales. So you can buy that Corvette at a very, very good price today.

Q. Let me ask you this. You have indicated you have been in the real estate business; I believe you said 32 years?

A. Yes, sir.
Q. Mr. Miller, is this the worst real estate market you have seen in that 32 years?
A. In the '80s it lasted around six years, and we have not lasted six years thus far. The downturn in the market, my income dropped to about 20 percent of its regular income.

Keep in mind throughout this whole entire time I have never done something else for a living. From the time I left the construction industry to the time I went into the real estate business I stayed in the real estate business. I endured the '80s, despite the fact that my income dropped to about 20 percent for about six years. It was difficult. I had kids in college. I had a lot of bills to pay. But I am a conservative old Mormon boy and we kind of had a lot of our things already paid for. And as a result, we were able to kind of survive those years.

I would say this is far more devastating of an economy at this point in time. And obviously the policy change didn't add any pleasure to this particular devastation.
Q. Mr. Miller, when you refer to the 1980s period, are you talking about what people generally refer to as the savings and loan crisis?

A. Well, it began with actually the interest crisis. Before the savings and loan crisis took place, at the end of, I guess I won't say any names, but at the end of a specific president's time, when 19 and three-quarters percent was the interest rate I had to pay to build a new custom home that my wife and I planned for a 10-year period. That was the cost of our construction loan. It was 19 and three-quarters percent. That was kind of the beginning.

From there it domino affected -- from that particular interest and inflationary period, that interest rolled over into what you would call a savings and loan crunch where we lost, I think, all but one savings and loan association here in Arizona, as I recall, and where the RTC took over everything and seemed to fire sale properties at an absurd and ridiculous rate just to be able to move properties and say they were gone and off the books.

Q. Mr. Miller, you are aware that not every Arizona electric utility had the same line extension policy in place prior to the company's current change in line extension policy, correct?

A. I am not aware. I thought Salt River Project had also a thousand foot free policy. That was my understanding. But the properties that I have sold, most of my parcels have been within APS' district.

Q. Okay. But Tucson didn't allow a thousand feet, did they?

A. I have not sold an awful lot of property in southern Arizona at all. Most of my marketing has been done in the greater Phoenix area.

Q. Okay. Do you know whether UniSource Electric serves the northwestern part of the state and the southeastern part of the state?

A. I do not. I know that the Kingman market is a completely different market, but I have not done much of anything. I have had sales in those areas but they primarily have been for Phoenix buyers and sellers, nothing where I have had to incorporate the research of power extensions, et cetera. It is just primarily flip and trade of investments.

Q. Do you know whether any of the rural co-ops in Arizona allowed a thousand free foot?

A. I have not sold a property within a rural co-op, so, no, I am not aware of that, not to my knowledge, unless you are speaking of something like ED-7 or the electrical districts that are available for a specific cooperative agriculturally. I have a little bit of, you know, a little bit of experience there.

Q. To your knowledge does Salt River currently still allow a free extension?

A. I believe they do but I am not positive of that. I woke up this morning and didn't read the paper.

Q. Have all land sales continued a pace, if you will, in Salt River's territory?

A. I haven't sold a property -- I have sold one property in the last 19 months. And I work every day all day. I still represent people, and I will be on the phone as much as I can today trying to make something new of this market. But I have not, I have not sold a piece of property in the Salt River district area whereby that research was necessary. So I couldn't tell you whether they do or do not have an upgrade in sales.

Q. Okay. So I take it the one piece of property you did sell was in the APS service territory?

A. It, in fact, it was. It sold two years ago for $220,000. The people needed money badly. We lowered the price again and again and again. And we sold the property again at 39 nine they bought for 220 cash two years ago.

Q. Let me ask you, Mr. Miller, if I construct a home in a rural area, I will need water service, correct?

A. Always you need water service.

Q. And I will either have to pay the cost of drilling, outfitting a well or, if there is a water provider in the area, I would have to pay for them to extend facilities to my home, correct?

A. Absolutely.

Q. And with regard to sewer service, I will either have to get permitted and construct and install a septic tank at my own expense or, if there is a sewer provider in the area, municipal or private, I would have to pay for the extension of sewer facilities to my residence, correct?

A. That is correct.

Q. And if I want trash collection, and again I am in a rural area where there is no municipally supplied trash collection, I will have to hire a private firm to haul my trash, correct?

A. To my knowledge that's an option in many areas.

Q. So I guess, Mr. Miller, if, if I wish to live in a rural area and I have to pay for my water service, and I have to pay for the installation of my sewer service, and I have to pay for the extension, if I wish that, of trash collection services, why should I not have to pay for the extension of electric service?

A. I didn't say that you shouldn't have to. I said that there was always a policy in place that made rural Arizona a very, very attractive thing. Rural Arizona is no longer as attractive as it was as a result of the change in policy. There has always been expenses. You also have to erect the home. You also have to erect a road to your property. There are expenses that go along with any rural development.

I am just speaking of the difference between then and now, when the policy was in place and the policy is now not in place. That's the difference I speak of.

Q. Okay. And to follow up on that, would you agree, Mr. Miller, that the thousand foot allowance was a subsidy to those customers who received it?

A. I think it was, I think it was a synergistic policy. I believe it also extended APS' lines and gave them many new opportunities where the moment it was extended to that particular property, it also opened up everyone within a thousand feet of that new property to be a possible service customer. And I have seen this happen for 30 some odd years, where these customers continue to grow off of the last extension.

Q. And lastly, Mr. Miller, if there has been testimony in this proceeding, and I will ask you to accept that, that the level of investment that is supported by the electric service that is sold to a new customer is something in the area of $2,000 or so, why should a customer receive anything more than a $2,000 allowance with regard to new service?

A. I am not a utility and I can't really respond to that answer.

MR. MUMAW: I don't have anything else. Thank you, Mr. Miller.

THE WITNESS: Thank you.

CALJ FARMER: All right. Mr. Crockett, do you have questions for this witness?

MR. CROCKETT: I just have a couple, Your Honor.

CROSS-EXAMINATION

Q. (BY MR. CROCKETT) Good morning, Mr. Miller.

A. Good morning.

Q. You are aware that there has been an economic downturn in the State of Arizona, are you not?

A. It is an economic downturn globally, but yes, it has happened in Arizona as well.

Q. And do you have an opinion as to approximately when that economic downturn commenced?

A. I would say it was completely well underway by 2007.

Q. And that would include the 19 months that you have not sold other than one lot, is that correct?

A. That's correct.

Q. And, Mr. Miller, are you aware of any vacant lots in the rural areas that have access to electric service that were sold during that period of time?

A. Yes. The property that I sold two weeks ago has electric service across the front of it.

Q. And that property was reduced from $220,000 two years ago to 39,900, correct?

A. As an economic response, but also because of the fact that that power now doesn't get extended from across the street into the people without a substantial expense.

Q. Okay. Are you aware of, other than the one lot that you have referred to, other lots that have had access to the electric utility service during this economic downturn that have sold?

A. Yes. There have been many.

Q. Are you aware of lots that have not sold that have access to the electric service during this economic downturn?

A. It has been my advice to my customers and clientele that, if they have the holding power, this is no market to sell in and to hold on for a better market and the potential of the thousand foot free return. Both of these things will be a great benefit to any of these people that want to hold their property or have the ability to hold.

They call me and say I need to sell property. A very good case study on this one would be a very good friend of mine, a gentleman who used to work at the front end shop of Midway Chevrolet. His name is Bill Tewhill. Years ago I sold him a parcel out by 331st Avenue, or I think 355th Avenue actually, just north of Salome Road. And I own the parcel right next to it. We got the properties together when they became available way back when thinking they would be good for a future investment. And they have been. Their property value went up to 30-, $40,000 range.

He called me about two months ago and said I am purchasing a property in Flagstaff, I need to get this thing sold, just dump it, get what you can for it, thinking along the $30,000 terms. And my research returned three sales that took place within about a quarter of a mile of our properties of $5,000 each, all of them bank owned properties that were dumped onto the market.

I can't tell you that a 100 percent of that was as a result of our economic downturn. I believe the fact that those properties depend upon the thousand foot free extension has an effect.

Q. But you don't have personal knowledge that that's the situation, do you?

A. I am not aware of anyone who called for power, found out they couldn't get it and said no, I cannot get it, I can't afford it in this particular situation.

Q. During this 19-month period of an economic downturn in Arizona, are you aware of homes that have been constructed during that period of time in the rural areas?

A. Yes. There still have been a minimal amount of construction taking place, but very, very, very minimum. It is extremely reduced.

Q. Are these custom homes or are these premanufactured homes?

A. It is a combination. A lot of people like the manufactured homes because of the convenience. You know, you just make a phone call and somebody gets a building permit. Next thing you know somebody is on-site setting things up and pouring slabs, pouring things in, and a home just shows up. A lot of the others have been built. But there is a good combination of both in rural Arizona.

Q. It is not your testimony that the only reason the lots are not selling in the rural areas or homes are not being built in the rural areas is simply because of the elimination of the Arizona Public Service thousand foot free build, are you?

A. No, that's not my testimony that that's the exclusive reason. That's just a contributive reason.

Q. Wouldn't you agree with me that one of the major considerations is the economic downturn?

A. One of the major considerations is.

Q. If I were to give you a hypothetical of a developer who developed and constructed the off-site improvements in a subdivision for the sale of lots that has electricity extended to those lots, has water service extended to those lots, those lots came onto the market in 2008, but to date not a single lot has sold, you would agree with me that it had nothing to do with the fact that there was not a thousand foot free build, would you not?

A. In that instance, you are absolutely correct.

Q. Hopefully we are going to see a change in the economic market; would you agree with that?

A. I am probably hoping more than you.

Q. And when do you think it will occur?

A. That would take a crystal ball. In the '80s I was confident it was going to be over in two to three years due to the fact that the market had begun a little bit of a pickup. And then when the RTC started dumping

properties, it drooped us for another four years.
Q. You would also agree with me, would you not, that not only will there be a lesser value attached to these rural lots, that there also will be a lesser value attached to homes that are constructed in metropolitan areas?
A. As well as the properties themselves, yes. There is going to be a huge drop in taxation this coming year.
Q. Were you in the hearing room when Commissioner Pierce testified about the fact of the home that he owns in east Mesa having dropped in value of $250,000 and that he did not anticipate that he would see a restoration of that value?
A. I did not. I was not here.
Q. So you would agree that other than the elimination of the thousand foot free build, that there are many, many other factors that are affecting the value of land in rural areas as well as metropolitan areas, would you not?
A. Absolutely, there are other factors. But we can't deny the fact the thousand foot free is also one of those factors.
Q. But I just gave you a hypothetical, a situation where a developer has not been able to sell his lots

even though he does have electricity extended to the lots.

A. I have a development at 67th Avenue and Jomax Road that I represent the sales of. I don't own the lots. I just sell the lots for the builder. And he is in the same situation. Things have been so, so slow. There have been sales that have taken place, not through me, in the development, but it has been very, very slow respectively, but not quite as slow as rural Arizona has slowed. It just seems to be almost a deadlock out there.

MR. CROCKETT: Thank you, Mr. Miller.

THE WITNESS: You are welcome.

CALJ FARMER: Mr. Robertson.

CROSS-EXAMINATION

Q. (BY MR. ROBERTSON) Good morning, Mr. Miller.

A. How are you?

Q. Despite the fact that you did not bring your crystal ball with you this morning, I am going to explore that a little bit further. I have two areas in which I wish to pose questions to you. And as the background for the first one, I am going to provide you with a little bit of context and then I am going to elicit your opinion.

I happen to be one of those people to whom you refer who lives in rural Arizona. I live in Santa Cruz County. I live just outside the community of Tubac. Living there, any time we go shopping for basic necessities, we either drive 20 miles north to Green Valley or 20 miles south to Nogales. And for anything beyond your basic day-to-day needs, we drive 45 to 50 miles up to Tucson. So gasoline, I am sure you can appreciate, is a very important part of our lifestyle.

I would be interested in your opinion as to the impact of the experience of the past year to year and a half of people paying on the order of $4 a gallon for gas, what impact that might have moving forward with regard to the desire and the ability of people to live in rural areas. Wherever you might be in the state, particularly since there is no guarantee or certainty on what fuel prices might be in the future, and now that people have experienced $4 a gallon, might that be a factor in their thinking as they move forward with their lifestyle decisions?

A. That's a very good question. I believe that the first major bump in the fuel price, when they went to $4 plus, we were still in a booming 2006 as I recall. And our sales were brisk at best. I mean they were still going quite well in the rural communities.

There is a tradeoff. Moving out, you sell off a -- you sell a large expensive home in the Phoenix area, you can get a larger piece of land, almost an equivalent home in rural Arizona. And the tradeoff was one such that I believe that they were willing to take the difference in gas even at $4 a gallon price. Now that we are at 2.77 this morning as I passed this morning for premium fuel, which the car which he is going to be purchasing uses, it is not quite as much of an impact but it is definitely a factor. That has always been a factor. I sold land in the first gas crunch at that point in time and it was a factor then.

But I think that the mystique and the desire that drove you out to the Tubac area is the same thing that drives others. And it is somewhat of a tradeoff, where they say there are be going to compromises to make this move, I will have to just bite the bullet on some of them. Fuel prices seem to be one of the compromises they have accepted. Right in the heart of 2006 when our market was up and prices were up on gas, it appeared to me that there was no lack of sales in rural Arizona at the time.

Q. Do you feel that the severity of the current recession, which for many potential homeowners and actual homeowners may be a relatively new experience, particularly if they are young enough they didn't appreciate the recession of the early 1980s, do you think that might alter how they might otherwise have approached this fuel tradeoff decision to which you alluded a moment ago?

A. I have not seen it with the fuel trade off. I know it is a factor with the youth, that they have not seen this before. A good example would be my daughter who bought a home in the Surprise area. It is 25 miles beyond our house.

And there is an awful lot of activity going on at our home on any given evening. I have six children and any four of the six may frequent the home, and if not more. I have one daughter who moved to California who doesn't count, so to speak, because she doesn't hang out a lot of with us anymore, but we are still together about once a month.

But my daughter in Surprise moved way out there because she wanted to be able to get a little more home for the value. And that took place in around 19, I think -- I am sorry -- 2002 or '3 when they purchased their home out there. They have since seen that home value drop about $100,000 below what they paid. And the disappointment is there. The gas and expenses are there. But they have not made a decision to move back into town amid the fact that they have had a little rebound in price tags on their house and they could get out for what their mortgage is and make a move back into town. That has not been a decision yet. So I don't think the gas prices have affected them as much. Her husband works at The University of Phoenix and drives all the way to central Phoenix every day. And that's, it has not affected them yet.

So as a personal experience, I would say not quite as much as we might expect.

Q. As I listen to you, your response appears to contemplate people currently living within the state in the sort of decisions they make. Now, in the past, there have been a number of people from out of state relocating to Arizona for lifestyle considerations. Among those have been the ones who wanted to locate in rural Arizona.

Do you think the recent economic experience and the $4 per gallon gasoline experience might alter the thinking of those out-of-state people and their decision as to whether or not to move to Arizona and whether or not to move to a rural environment, independent of any line extension policy from the local utility?

A. That's a tough question. I really don't know that I have a specific experience to relate to that.

I have no doubt that it affects some. And I also have no doubt that there are some who would gladly make the change for other lifestyle reasons. I know my daughter living in California would love to be back in Arizona for a number of reasons that you have asked me to exclude. And I think that if she were to come back here, to be able to have her children in a rural environment would be better for her. Based on our lifestyle in general, we like the rural environment rather than being crammed in amongst the people.

Q. Okay. Let me move now to the second area I wanted to explore. And I am going to use a phrase you used in one of your responses. And that is the 1,000 foot free return. I am going to pose a hypothetical to you as a predicate for my question.

Let's assume that the Commission, after evaluating all of the evidence in this record as to all issues, not just the line extension policy issue, decides that in order to accommodate a return to the 1,000 foot free policy which previously existed it will be necessary to provide for an overall rate increase above the level currently proposed in the settlement agreement which is before the Commission. And that would be a rate increase that would affect all APS ratepayers. Would you want that to be a necessary outcome in order to have a restoration of the thousand foot free footage allowance?

A. I believe it would be a very good tradeoff in my opinion. Rural lifestyle is an awful lot more than just dollars and cents.

Q. This would be a rate increase above and beyond what the settlement agreement provides for that would apply to all APS ratepayers, not just rural. Is your answer that you believe that would be a good policy decision for the Commission?

A. I live in a residential subdivision, 83rd Avenue and Deer Valley Road. I would gladly take that increase to be able to see rural Arizona restored to its regular booming lifestyle. It picks up construction. It picks up land valuations. It picks up, restores investment. It restores an awful lot of good things in my opinion.

Q. Now, your livelihood comes from the rural Arizona land market, correct?

A. That's what I do for a living.

Q. Okay. Do you believe other APS ratepayers who do not derive their livelihood from that sort of activity would share your view?

A. I believe many would because they have invested out in rural Arizona. I believe there are some who absolutely won't and who will specifically look at their own dollar and cents, their specific checkbooks, not look at the global need, that would selfishly say I don't think it is fair. But it seemed to work quite well for APS for many years.

MR. ROBERTSON: Mr. Miller, that's all I have. Thank you, sir.

THE WITNESS: Thank you.

CALJ FARMER: Do any of the other parties have questions for the witness?

MR. POZEFSKY: No.

CALJ FARMER: Ms. Pecora, did you have any follow-up questions for your witness?

MS. WYLLIE-PECORA: Just two.

REDIRECT EXAMINATION

Q. (BY MS. WYLLIE-PECORA) We are due to get some tax bills here soon on our property and homes. And any rural areas all over the state will get tax bills. Is there something that you foresee happening with the valuation of this property in the rural areas in the future?

A. Absolutely, with a number of apostrophes, I mean a number of exclamation points behind it. Let me tell you a little bit about what is starting to take place at this point.

A lot of my clients have already called me and say they are very uncomfortable with their current taxation. And even though they dropped back a little bit for the 2009 evaluation, they didn't drop back far enough. Now they are seeing the reality of what is happening out there in the market.

A good example will be my friend and I who own our eight and a quarter acres out there at 355th Avenue, Bill Tewhill who I responded to. His property valuation is currently $35,000. Mine next to him is the same. With properties having sold in the immediate vicinity of $5,000, don't believe for a minute that we are not going to be protesting 100 percent of our tax value back to that $5,000 value.

I own a custom home lot that my wife and I had hoped to build a big beautiful custom home on while our market was going very well at 133rd Avenue and Happy Valley Road. It is about a mile and a quarter, or not even a mile and quarter, it is approximately a mile away from the lot that I just sold for 39 nine. My property is valued at 305 by the county. And I just sold another lot at 39 nine.

You can only imagine the impact this county is going to see once I finish with my reevaluation. And my clients are the people that buy the lots around me. I sold, in proximity from my lot, I sold I think about 75 lots within about a half mile radius of my lot. Almost all of those are my clients, are customers. I am going to be helping them reassess their values.

Valuation is going to be a substantial drop back. A lot of it is due to our economic circumstances. But the lack of the thousand for the free policy is not absent from that responsibility. And there is, I don't know how to quantify specifically that exact amount, but it is part of it all. We have many instances where people now will have to pay more to bring power to their property than they paid for their property. That was not the case when they bought.

Q. Okay. So there is no way we can come up with a dollar value that the state is going to lose in revenue based on the decrease in value on the property tax?

A. Exponential is the word I would use.

Q. And that's probably statewide?

A. I am sure that it is.

Q. Okay. That is my last question. Do you have anything else that you would like to add?

A. No. I know the market is tough. I know economics are tough. And I know that we need all the breaks and help we can get. This is, in my opinion, this particular policy happened to be the wrong move at the wrong time, really the wrong move at the wrong time.

There are probably a lot of ways to adjust APS' rate. I have no interest in knowing what you gentlemen know. I have no interest in doing what you do or trying to accomplish what you accomplish. But I know how this will affect the state. And I think this particular move may have been one that was either rash or unquantified prior to doing so because of the devastation that is going to take place out there and that is already underway.

There are a lot of people whose hopes and dreams all lied upon their property that they purchased in the last 10, 15 years. They invested in those properties. They have got them now paid off. They are excited to move out there, and that's not a possibility any longer due to the expenses that have increased.

I mean a lot of the expenses have gone down. A lot of the argument has been how the economic circumstances have impacted globally. Well, let's look at the fact you can build a house, you can build a house now --

(Telephone rings.)

CALJ FARMER: Let's go off the record here for just a moment.

(An off-the-record discussion ensued.)

CALJ FARMER: Sorry for the interruption. Let's go ahead and go back on the record.

THE WITNESS: I believe an awful lot has been made about our economic downturn is a great factor along with the thousand foot free. One of the things that escaped us in most of this conversation is the fact that to build a house, a custom home like the one I was getting ready to build, was $250 a square foot based on the equipment and supplies that were going into that house. I can now build that house today at 105 for a foot. I think that's very, very attractive to the average person and they would like to get out and build right now while these costs are low.

Financing is part of the problem. Our economics are part of the problem. They are not making as much as they were and do not feel as comfortable, not as easy to go get their mortgage loan. But they are dying to get out there to rural Arizona and to go build those homes at these great rates, to buy concrete at the price it is today rather than 2006. To buy all the materials and equipment that goes into a house has been a very attractive thing. There are a lot of people who would like to move forward, but now they have got a new huge stumbling block in front of them with that thousand foot free being gone. And that expense has now, it has crushed an awful lot of dreams. I would love to see -- I would respectfully request the return of that policy.

MS. WYLLIE-PECORA: Thank you.

CALJ FARMER: Anything further for this witness?

(No response.)

CALJ FARMER: Thank you, sir, for your testimony today. Let's go off the record here.

(Brief recess.)

CALJ FARMER: Let's go back on the record.

RUCO, are you ready to call -- just a minute. Staff.

MR. HAINS: I thought Mr. Lewis was going to be next, Mr. Mike Lewis.

MR. MUMAW: Phone guy.

MR. HAINS: Phone guy, yes.

CALJ FARMER: All right.

MR. HAINS: Were we incorrect on that?

CALJ FARMER: No. I don't know. If everyone thought that was next, then that's fine.

MR. GRANT: That's the order I had.

CALJ FARMER: And is there any time constraints for RUCO's witness travel-wise? I just wanted to see if his --

MR. POZEFSKY: Good morning, Your Honor. Dr. Johnson is here and available all day.

CALJ FARMER: Okay. All right. Then we will take Staff's witness next, but evidently he needs to call back in.

MR. HAINS: That's correct. Actually, Your Honor, I apologize for the disruption, when it happened. That was our plan, was to ask for a brief recess and let him know to call in at that time.

CALJ FARMER: Let's take a break here then and come back at ten until 11:00 by that clock.

(A recess ensued from 10:34 a.m. to 10:53 a.m.)

CALJ FARMER: Let's go back on the record.

Staff, are you ready to call your next witness?

MR. HAINS: Yes, Your Honor. Staff would like to call Mr. Lewis.

CALJ FARMER: Mr. Lewis.

THE WITNESS: Mr. Lewis is present on the phone.

CALJ FARMER: The court reporter will need to administer the oath to you. Hold on just a moment.

WILLIAM MICHAEL LEWIS,

a witness herein, having been first duly sworn by the Certified Reporter to speak the truth and nothing but the truth, was examined and testified as follows:

DIRECT EXAMINATION

Q. (BY MR. HAINS) I guess it is good afternoon, Mr. Lewis. How are you doing?
A. I am fine. Good morning to you.
Q. Thank you. First, if I could have you give your full name and place of business for the record.
A. My name is William Michael Lewis. Business address is 934 Valley Street, Wheelersburg, Ohio 45694.
Q. Thank you. And by whom are you employed and in what capacity?
A. I am employed by W.M. Lewis & Associates. And I am at present the principal engineer.
Q. And on whose behalf are you testifying today?
A. I am testifying on behalf of the Staff of the Commission.
Q. And in the course of your evaluation of this application, what areas were you assigned to analyze?
A. We were to analyze aspects of APS' quality of service, their reliability indices, the status of

various projects that were being proposed for inclusion into rate base while they were actually construction work in progress. Those were the major items of evaluation.

Q. I see. And did you or your associates prepare written testimony in the course of that evaluation of the application?

A. We did.

Q. Okay. Do you have with you a copy of the prefiled testimony of Kenneth Strobl?

A. I do.

Q. And can you read how that is identified.

A. It is identified as before the Arizona Corporation Commission in Docket No. E-01345A-08-0102, direct testimony of Kenneth Strobl on behalf of Staff, Arizona Corporation Commission, December 19, 2008.

MR. HAINS: Okay. And, Your Honor, for purposes of identification, Staff has marked Mr. Strobl's prefiled testimony as Exhibit S-4.

Q. (BY MR. HAINS) Mr. Lewis, are you sponsoring Mr. Strobl's prefiled testimony which has been marked as S-4?

A. I am.

Q. Did you have changes, modifications, or corrections to make to Exhibit S-4?

A. None that I am aware of.
Q. Okay. If I were to ask you the questions posed in Exhibit S-4 would your answers be the same as provided in the exhibit?
A. They would.
Q. Okay. Do you adopt Exhibit S-4 as your sworn testimony here today?
A. I do.
Q. Mr. Lewis, I wanted to ask you, you did prepare another document related to an accident that occurred at APS' Saguaro generating plant on December 2nd of 2008, is that correct?
A. That is correct.
Q. And do you have a copy of that document with you?
A. I do.
Q. And can you read how that document is identified.
A. I would identify the document as a memorandum. It was to Terry Ford, Arizona Corporation Commission Staff, from myself and Mr. Strobl. It is dated August 19, 2009. The reference is APS lineman fatality, December 2nd, 2008. My copy is in two pages. The final may be in one. I am not sure of that.
Q. All right. And just for clarification purposes,

you noted that there is a difference between what you have and the final. I have in front of me a version that is actually written to Mr. Elijah Abinah and it is dated September 4th, 2009. Does that sound --

A. That is the final version, yes.

Q. Okay. As between the final version and the version you have, are there any changes other than who it is from and the date of the document?

A. Not to my knowledge.

Q. Okay. And did you prepare this document?

A. I did.

Q. Okay.

A. In conjunction with Mr. Strobl.

Q. Thank you.

And actually, before I get that far -- and, Your Honor, this exhibit has been marked as Exhibit S-18 -- and, Mr. Lewis, if I were to ask you questions based on Exhibit S-18 would your responses be the same as expressed within the memorandum?

A. Yes, they would.

Q. Okay. Do you have any changes, corrections or modification to make to Exhibit S-18?

A. I do not.

Q. Do you adopt S-18 as your sworn testimony today?

A. I do.

MR. HAINS: Your Honor, Staff would like to move for Exhibits S-4 and S-18 to be placed in evidence at this time.

CALJ FARMER: Okay. The copy of the testimony S-4 that has been marked by the court reporter ends on page 10 but it looks like it is not the end of the testimony.

MR. HAINS: Your Honor, we will track that down and get a complete copy.

CALJ FARMER: Do you know how many pages it should have?

MR. HAINS: Find out in a moment.

CALJ FARMER: Okay.

MR. HAINS: Your Honor, it is approximately 29 pages and there is an appendix attached to it as well. But we will get a conformed copy, correct and complete copy for the court reporter. I believe that a complete copy should have been filed in the docket however.

CALJ FARMER: Okay. I will make a note here that we need the complete copy. But I will admit S-4.

And S-18 was filed after the deadline for any objections, so let me ask if any party has any objection to Staff Exhibit 18.

MR. GRANT: No.

MR. CROCKETT: No objections.

CALJ FARMER: Hearing no objections, S-18 is admitted.

Let's go off the record for a moment.

(Exhibits Nos. S-4 and S-18 were admitted into evidence.)

(A recess ensued from 11:00 a.m. to 11:07 a.m.)

CALJ FARMER: Let's go back on the record.

And while we were off the record, Staff provided a complete copy of the Staff Exhibit S-4 to the court reporter and provided me a copy. Thank you very much.

Okay. So both S-4 and S-18 are admitted.

MR. HAINS: If I may have a few questions for Mr. Lewis before I will cut him loose.

CALJ FARMER: Okay.

Q. (BY MR. HAINS) Mr. Lewis, are you still there?

A. I am still here.

Q. First I would like to ask you a few questions related specifically to the evaluation you performed regarding the Saguaro incident. First among them, have you performed similar analyses in the past?

A. I have, many.

Q. All right. And what materials did you use to base this specific evaluation on?

A. Primarily we used the ADOSH report and findings on the incident. Also APS provided me with copies of their accident prevention manual, and subsequently the APS safety and training data for 2009 and the contents of an e-mail from the vice president for energy delivery to all APS employees that was dated December 11, 2008.

Q. Okay. Did you reach a conclusion as to what was the technical cause for the accident?

A. I did.

Q. Could you please briefly describe how you reached that conclusion.

A. Using the facts as they were reported in the ADOSH report and conversation with some APS people, I think the source of energy that provided the electrocution could have been from two possible sources. One would have been the CCVT device that was adjacent to the work area and connected to the work area and the other could have been induced voltage from nearby energized overhead conductors.

Q. Okay. And you mentioned an acronym, CCVT. And I just wanted to confirm that stands for coupling capacitor voltage transformer, is that correct?

A. That is correct.

Q. In a letter from Chairman Mayes to the parties dated August 5th, 2009 that was filed in this docket, Staff was called on to explain the steps taken by APS in the wake of the Saguaro incident. Likewise, the letter called on Staff to consider whether additional steps are necessary. In the course of your evaluation have you prepared any suggestions?

A. I think as I referred to in your last question, the vice president for energy delivery took steps in an e-mail and directed that all concerned or to all APS parties that would be placed in a position of working on these type of lines, that they be given a further review of the safety measures to be taken and the dangers associated with it.

If I were to suggest to the Commission, I would have made a suggestion along very similar lines, that the Commission direct all their regulated utilities to step back and take an extra hour or two hours and that all linemen would be given this type of refresher in their training.

Q. One other set of questions here. For purposes of Commission rules, is there a standard that has been incorporated as relevant to a review of this incident?

A. I am informed that the Commission Rule R-14, and I believe it is 208, incorporates provisions of the National Electric Safety Code, which would cover this type of incident and, in fact, would cover most safety aspects of an electrical utility.

Q. Okay. And just to provide a complete reference, would that be Administrative Code Rule R-14-2-208, specifically paragraph F(1)? Does that sound familiar?

A. Subject to check, and my notes agree with you. Yes, that would be the correct rule.

Q. Okay. Thank you. And just briefly, can you explain, what is the national electrical safety code?

A. National Electric Safety Code is prepared by the Institute of Electrical and Electronic Engineers. It is a summary of proper work construction and work safety codes. It is promulgated as a voluntary standard to be adopted by regulatory agencies to form the basis for the individual utilities to develop a comparable or better set of safety standards.

Q. I see. Thank you.

And, Mr. Lewis, you have not evaluated for purposes of potential enforcement whether additional formal Commission action is necessary, is that correct?

A. That's correct.

Q. And if I may, just why not?

A. Well, all the facts are not in as far as I know. And we were awaiting a final determination between ADOSH and APS as its ongoing talks.

Q. Okay. Just following up on that, specifically the ADOSH matter that you discussed, do you think as a compliance matter it would be useful for APS to file notification of the ultimate result of the ADOSH process?

A. I would indeed, yes.

MR. HAINS: Okay. Thank you very much, Mr. Lewis.

With that, Your Honor, Mr. Lewis is available for questions.

CALJ FARMER: All right. Do parties have questions for this witness?

MS. GRABEL: Just a couple, Your Honor.

CALJ FARMER: APS.

CROSS-EXAMINATION

Q. (BY MS. GRABEL) Mr. Lewis, hi. This is Meghan Grabel from APS.

A. Hi.

Q. I just have a couple questions that related specifically to the fourth paragraph of your memorandum, which is Staff Exhibit 18.

A. Yes.

Q. Do you have that before you?

A. I do.

Q. You indicated in response to a question from

Mr. Hains that your conclusion in that paragraph was largely based on information that was contained in the ADOSH report and findings regarding the incident, is that right?

A. That's correct.

Q. And do you understand that the ADOSH findings are preliminary in nature?

A. I do.

Q. And you are aware that APS is currently contesting various aspects of those reports and findings?

A. That was my understanding and my reason for the form of the answer I gave prior.

MS. GRABEL: Thank you very much, sir. That's all I have.

CALJ FARMER: Any other parties have questions for the witness?

(No response.)

EXAMINATION

Q. (BY CALJ FARMER) Okay. Mr. Lewis, I may have just a couple. The testimony that you are adopting from Staff witness Mr. Strobl --

A. Yes, ma'am.

Q. Okay. Do you have a copy of that with you?

A. Yes, ma'am.

Q. Did you make these site visits with Mr. Strobl?

A. I did. And just to carry on with that, I made one without Mr. Strobl.

Q. Okay. On page 7 of that testimony --

A. Yes, ma'am.

Q. -- you are talking about the company's performance and various measurements for the past three years?

A. Yes, ma'am.

Q. And down on line 17 there is a Q and A about what can an observer imply from the above values.

A. Uh-huh.

Q. Can you explain for me, is this -- and I am just not sure from reading this, whether this is something that APS needs to improve on or whether you think their results are ones that the Commission should find acceptable.

A. I think the Commission could find APS' performance acceptable. And not to be trite, but there is always room for improvement. And I offered some target values for the indices that I would like to see APS strive to meet. That would be in the next question there, ma'am.

Q. Okay. Thank you.
And on page 9, you also recommended that the Commission be informed of the company's results on a regular basis.
A. Yes, ma'am, at least on an annual basis. And I would also add that any significant outage should be reported to the Staff within a reasonable time of its occurrence.
Q. Okay. But in just a general kind of overall evaluation or observation, how would you describe APS' plant and infrastructure in terms of its quality, age and condition?
A. I would give it a B plus to an A minus overall from what I have seen.
Q. Okay. And how about the competence and training of its employees?
A. I think the competence, I can only speak to the engineers that I have met, and I find them very well prepared. After reviewing their training material that was provided as a part of looking at the fatality, it seems to be very well done.
Q. Okay. Thank you. And you also visited the projects that the company wanted to include in rate base?
A. Yes, ma'am, we did, several.

Q. Okay. And you verified that all of those are in operation?

A. They were either in operation or it was reasonable to conclude that they would be in operation by a date certain.

Q. Okay. And you believe that those projects are necessary to provide service to APS' customers?

A. I believe they are necessary to maintain the current level of service and reasonable expectations of increased demand.

CALJ FARMER: Okay. Thank you. Those are the questions I have.

Was there anything else that you wanted to add?

THE WITNESS: No, ma'am.

CALJ FARMER: Okay. Let me ask just your counsel if they have any redirect.

MR. HAINS: I do not, Your Honor. Thank you.

MS. GRABEL: Your Honor, may we ask one more question in light of your questions?

CALJ FARMER: Yes.

FURTHER CROSS-EXAMINATION

Q. (BY MS. GRABEL) Mr. Lewis, this is Meghan Grabel again from APS.

If you could turn back, if you would, to Staff Exhibit, is it, No. 4, the testimony of Mr. Strobl, you indicated in response to a question from Judge Farmer that APS' performance with respect to the SAIFI, SAIDI and CAIDI, for lack of actually wanting to spell out the acronyms, was acceptable.

Isn't it true that APS' performance based on your analysis placed APS' performance in the upper 25 percent of all electric utilities of comparable size for those years?

A. That is correct.

Q. You also indicated that you would like for the Commission to have, or APS rather, to report to the Commission and to Commission Staff its, APS', performance with respect to those metrics, is that right?

A. Yes.

Q. Have you had the chance to review the settlement agreement that is the subject of these proceedings?

A. I have not.

Q. Would it comfort you that one reporting requirement is APS is obliged to meet -- under Section 13.3(B)(a) actually requires APS to report on the frequency and duration of unplanned outages as measured by those metrics?

A. That's very heartening. We did suggest that and I am glad to see it is included.

Q. Are you also aware, sir, that the company routinely reports to Staff about the major outages of the type that you indicated before?

A. I was aware that that was an -- my belief -- okay. Let me start over again.

Yes, I was aware of that. It was my understanding that that was merely an informal agreement. And I just wanted to see it put down on paper for lack of a better term.

Q. And, in fact, in Section 13(B)(a)(ii), one of our reporting requirements is in fact to provide information regarding major unplanned equipment outages or downtime. Is that heartening as well, sir?

A. Very much so.

MS. GRABEL: Thank you very much.

CALJ FARMER: Any further questions for this witness?

(No response.)

CALJ FARMER: Thank you, sir, for your testimony today.

THE WITNESS: Glad. Thank you all. And I am sorry if I wasn't overheard well.

CALJ FARMER: Oh, we could hear you fine. Thank you very much. I will go ahead and hang up and I will disconnect you.

THE WITNESS: Thank you, ma'am. Bye.

CALJ FARMER: Let's go off the record here.

(Brief pause.)

CALJ FARMER: Let's go back on the record.

RUCO, are you ready to call your witness?

MR. POZEFSKY: I am, Your Honor. Thank you. RUCO at this time would call Dr. Ben Johnson.

BEN JOHNSON,

a witness herein, having been first duly sworn by the Certified Reporter to speak the truth and nothing but the truth, was examined and testified as follows:

DIRECT EXAMINATION

Q. (BY MR. POZEFSKY) Good morning, Dr. Johnson.

A. Good morning.

Q. Would you please state your name for the record.

A. Ben Johnson.

Q. And, Dr. Johnson, where are you employed and in what capacity?

A. I am employed as a consulting economist in a firm that is called Ben Johnson & Associates. And I am appearing today as a consultant on behalf of RUCO.

Q. Okay. And, Dr. Johnson, you have testified many times before this Commission, is that fair to say?

A. Yes, stretching back to the early '80s.

Q. Okay. Dr. Johnson you should have up there what is marked as RUCO Exhibit No. 5. Which is your direct settlement testimony; RUCO Exhibit No. 6, which is the underlying testimony; RUCO Exhibit No. 7, which is the rate design testimony. Were those testimonies prepared by you, Dr. Johnson?

A. Yes.

Q. Do you have any additions or any corrections to those testimonies at this time?

A. I have a few corrections I would like to make to the settlement testimony starting on page 9. I will flip to it.

Starting at line 1, where it says but more than the amount recommended by RUCO, I would like to rephrase that sentence so that it ends recommended by RUCO and Staff and similar to the amount recommended by AECC.

And I want to make a similar correction to lines 7 and 8 so that on line 7 it will read but it is less than $50 million, higher than the amount recommended by the Staff, about the same as recommended by AECC, and it is more than $100 million lower than the amount requested by APS.

The only other corrections are minor. On page 12, excuse me, page 20, at line 12, the reference to May 2008 actually should say April 2008. And at page 32, line 19, at the very end of the line it should say and APS. The word it doesn't need to be there in that sentence. Those are the only corrections I have.

MR. POZEFSKY: Okay. And, Your Honor, just for the record, these documents have already been admitted.

Q. (BY MR. POZEFSKY) Okay. I am going to ask you a few questions, Dr. Johnson, short direct if you will. I want to make sure we get all the points covered from RUCO's standpoint.

RUCO did not make a recommendation for a nonfuel base rate in its underlying case, is that correct?

A. Yes. We did not recommend increasing nonfuel rates in the underlying case based on a pure historical test year analysis. There was a discussion of the whole problem of attrition and its implications, but RUCO's primary recommendation was to reject the variety of adjustments to the test year in that having done so we wanted to show the Commission that that would result in no increase.

We did not recommend a decrease. We simply said that the historical test year standing alone was not sufficient to justify an increase in the nonfuel rates.

Q. Now, RUCO is recommending that the Commission approve a $196.3 million increase in nonfuel related base rates. Can you explain, Dr. Johnson, from an analyst's perspective the quid pro quo or what ratepayers are getting in exchange for the revenue increase.

A. I can. And I think it is -- maybe take a moment to step back and think about it.

The short answer is simply they are getting reliable service. They are getting electricity in return for that price that they are paying. So ultimately the question, the test for this Commission, is this a fair, just and reasonable price to pay for the service being provided.

One of the things RUCO likes about this settlement agreement is that given that rates were likely to increase in any event, by signing onto a settlement and designing it this way, of course we have increased the odds that the rates were going to go up. But there is something very significant that's being received in return, which is a greater assurance that service will continue to be reliable, that the concerns about financial metrics and concerns about future construction programs and the ability to finance those effectively will be ameliorated, so that, in essence, in return for taking what was a likely rate increase and converting it into a definite rate increase, what customers are getting in return is greater stability for many years into the future, not just the next couple years, with more stable rates, which is certainly one of the benefits, but also greater stability on the financial side from commitments that APS has made to make equity infusions and to strengthen its balance sheet, notwithstanding difficult conditions in the markets and a whole series of other provisions that in summary, in essence, are these performance measures which provide assurance that APS management is going to be focused on the concerns that RUCO has, that it is going to be focused on issues of greatest concern, customers, and that adequate management attention is going to be focused on an agreed upon set of benchmarks and an agreed upon set of specific measures that they are going to be monitoring and managing towards.

Q. Let's go through the agreement in a little bit more detail as well as address some of the issues that were raised in Commissioner Mayes' letter of August 5th, 2009.

Could you discuss what impact the proposed rate increase could have on customers in the midst of the current economy.

A. Well, clearly any increase is of concern to consumers no matter how small. And I don't want to suggest that a 7 or 8 percent increase is so small that consumers wouldn't notice it. Quite the contrary, they will notice it. And particularly those who are on fixed incomes, it will be of deep concern.

But RUCO is also realizing, and as recognized in its originally filed testimony as well as in its position taken in the settlement discussions, that the adverse impact on consumers of a financially unhealthy company would be far greater in terms of lost jobs, unemployment. It could be devastating to the local economy if APS were to be unable to finance its construction program and unable to provide reliable service. And even the whiff of that risk, the possibility of bankruptcy or the possibility of default or possibility of anything of that sort could cause tremendous adverse implications for all the customers of this area.

So we don't want to be taking even remote risks. And fortunately they are remote risks. But there are enough warning signs that have been there for several years. And when we were going into the settlement negotiations, we said, well, let's see if in this discussion we can convert this into something very constructive and try to ameliorate those problems at the root cause.

And I think there was a lot of discussion that very successfully brought forth what the core issues were and what could be done about it. And an attempt was made to share the burden of solving the problem and not entirely putting it on customers and not simply through rate relief, but also through appropriate refocusing on management's attention to certain benchmarks and a commitment to provide more equity and to strengthen the balance sheet, that ultimately we think this is of greater benefit to consumers than the 8 percent increase in nonfuel rates, the net of which may actually turn out to be somewheres in the order of 1 percent.

Again, it is not the fact that 8 percent is small or 1 percent even smaller. It is the fact that the benefit of having solid reliable electricity supply is significant. And being able to achieve that at very low cost effective rates is the ultimate goal of regulation, the goal of this Commission.

We think that this settlement is part and parcel of that long-term view, again, the prospective towards trying to finance a transition to more renewable resources which ultimately will have a more favorable cost trajectory, but getting there could be a little painful. So a lot of things are brought into balance in this agreement and we think it is a reasonable balance that has been achieved.

Q. Let's go to the rate case stability provision of the agreement, Section 2.1 and continuing thereafter. Does RUCO believe that these provisions will help ameliorate the impact and how?

A. We do. And I think the most significant, the most basic way is that when looking at the 8 percent increase, it properly needs to be spread over a two- or three-year period, that it is not an 8 percent per annum increase.

It appears to be 8 percent at this moment but it has been more than a year since the last increase. It has been a number of years since you had a really large nonfuel related increase. And going forward, with the assurance that we are not going to have an immediate filing days or weeks or months after this case is resolved, that there will be a pause in the rate cases, provides, from a calculation point of view, some very great assurance that we are looking at an 8 percent increase over at least a two-year period, possibly three or four depending how you want to look at it, so that in total, when looking at the amount of the increase and earlier increases and earlier rate cases, are we, you know, far above the inflation rate. I don't believe so.

I think that the overall long-term trajectory is reasonable considering Arizona is a growth state. And that's something very important to keep in mind. If you weren't in a growth state, you could be sitting there with depreciating balances of older technology, older plants that are being depreciated away. It is a lot easier to maintain low rates, notwithstanding increasing environmental requirements, notwithstanding increasing fuel costs and all the other cost pressures. When you are in a growth state, you are in a position of having to invest in new plant and equipment. And it is unfortunate but the reality of that in the electric industry, new plant and equipment tends to cost quite a bit more than what was being purchased 10 or 15 years ago. So it is really unavoidable that you are going to have upward cost pressures when you are in a state like Arizona.

When looking at the total picture, the fact that this increase is, in fact, going to be in essence spread over or can be spread over a multiyear period is very significant. And it allows us to put in perspective that 8 percent increase and realize that it is a reasonable amount.

Q. Let's move to Section 8 of the agreement, Dr. Johnson, which includes the equity infusions and the 52 percent debt ratio. Were these provisions important to RUCO, and why?

A. Yes, they were. There is a multiplicity of reasons why they were important. Let me start with just a few of them.

First, that there had been a series of requests for rate increases, including the interim request in this proceeding and earlier proceedings, in which sort of the hard fact that you were dealing with that was being presented to the Commission was that, notwithstanding all the other arguments pro and con about different ratemaking theories and different approaches to calculating rate base and the like, that you really didn't have a lot of discretion in resolving some of those issues because you had concern about the bond ratings.

And one of the things that RUCO asked me to look at from the very beginning was to look at those issues and to look at how much merit was it. And I concluded, and was very forthright about that in the original filed testimony, that there was significant concern about their bond rating, that they were at the very low end of the entire industry. They are one of the, perhaps the fifth from the bottom of their comparable group of a very large number of companies in terms of how much the bond rating agencies are looking at this company.

That is not a position you want to be in. It is nice to be at the head of your class. It is not so good to be at the bottom of your class. And it is not so good at a time where it has become even more significant over the time period of this case when the rating agencies were under and continue to be under significant scrutiny from the government that basically authorizes them to be in the position they were in through the sort of monopoly arrangements that the federal government has in authorizing certain rating agencies. And their information to be relied upon haven't done a very good job in the mortgage, collateralized mortgage obligation areas and other areas. So they are under scrutiny not to sort of let minor problems go and let's just let it go. They are under tremendous pressure right now to be very tough and accurate, and fair, but to be tough.

And so then you don't want to be in a borderline situation. You don't want to be the poster child of how the rating agencies are getting tougher. That's not something you want to be in that situation. You want to be able to send some signals to the rating agencies that this is a strong company and it is going to be stronger over time and not give any sort of reasons for the rating agencies to downgrade them. You are already sitting right at the edge of moving into a non-investment grade category.

I think we should digress for just a moment and make sure the Commissioners understand the significance of that. And it relates directly back to this role that the government has in sort of setting up S&P and Moody's and Fitch as being these rating agencies.

There is concepts of prudence that apply to money managers. The banks in particular, they are regulated by the Federal Reserve. And insurance agencies, the major mutual funds, the major agencies that are the intermediaries between people who ultimately have money and the institutions that receive money, they have a criteria, the concept of investment grade. And they are basically saying that it is prudent for investment grade bonds, but anything below investment grade is moving into a more speculative category that is limited. So it is a very limited subset of agencies and entities. And even for insurance companies and others that might be allowed to invest in them to a small amount, there are severe limitations on how much money they can safely invest below investment grade.

So it is kind of like a cliff. If you drop off of it, it is a significant change. It is no longer just a mild little shift in your interest costs, we are just going to bump another tenth of a percent. Potentially it is very significant.

When you combine that with the time period that we have just been going through, we are not necessarily out of the woods yet, in which there has been a risk aversion, there has been a flight to quality that has been going on, it is not at all clear that APS could even raise the capital amounts that they need, in the order of half a billion or billion dollars a year, if they were below investment grade. Are there enough institutions out there with that kind of capital willing to write checks to provide funds even with 20 interest rate, it is not clear. Hopefully there would be. Hopefully they could find enough entrepreneurial folks out there willing to invest, maybe wealth funds from the Middle East or whatever. Somebody out there may take a 20 percent interest rate. But it is not clear there would be any. We can't just assume that if they lose the bond rating all will be well.

So there is this concern. And we talked about it. And I talked about it in my original prefiled testimony. And it became of even greater concern as the market started dropping in December for stocks. And as we were carrying on these negotiations the market dropped even further. And it became clear that the ultimate solution was either customers were going to potentially have to fund the construction program or, if they did not have the bond rating and we need the construction, you have to have some sort of extraordinary surcharges or something of the like, which would be very painful for customers, or we are going to need more equity. And it would be far better to get that equity assurance now rather than trying to get it at very unfortunate circumstances down the road.

So from RUCO's point of view, trying to get assurance that we are going to have more equity in the company so that the metrics are stronger, there is being less risk taken by bondholders so it is reasonable for them to lend at more reasonable interest rates, and so that customers won't be brought into the position of being the ultimate guarantors -- and, again, I don't want to -- take an example of something like a bankruptcy scenario, which is, you know, the absolute worst possible scenario that could ever happen, certainly would never happen in this company. But just paint a picture in your mind, what would a federal bankruptcy do. He would order higher rates. And notwithstanding this Commission, he would say you want power, you are going to have higher rates if you need to pay these suppliers.

It is, you know, the -- so the point being ultimately customers have risks that they are taking. And to avoid moving from one-thousandth of one percent risk of that to one-tenth of one percent is significant. You don't even want to be thinking those kinds of things and we don't want to think about them. We want to move past that. And we think being realistic about the bond rating, being realistic about the metrics and saying let's get the metrics stronger, they are not that weak. Where is the weakness?

The weakness is the FFO to debt ratio. That is the core problem. It is exacerbated by the debt ratio which is somewhat borderline at about 57 percent the way that the bond rating agencies look at it. Both of those can be improved with additional equity or less reliance on debt.

So that became a focus of attention for RUCO and became part of what you see in this settlement agreement.

Q. And, Dr. Johnson, in describing the current economy, you used an expression flight to quality.

Could you just explain what you meant by that expression.

A. Sure. In December 2008, specifically, we saw an extraordinary movement in interest rates for U.S. government securities, particularly 20-year and 30-year bonds relative to all other securities, most noticeably against the AAA bonds which are very stable. Normally there is a small gap in their interest rates because clearly even the best AAA rated corporate entity is riskier than the U.S. government, so people demand a little bit higher interest rate. But normally that interest rate gap is relatively stable and modest.

In December 2008 we saw that widen. In essence what the pattern was, the corporate interest rates stayed relatively steady at a time when the Federal Reserve was bringing short-term interest rates close to zero. So there was an incentive to move out of short-term instruments like T bills, move into longer term bonds and the like, which would normally drive down bond rates. The bond rates did not come down for AAA but they did come down for the federal government, 20-year bonds.

So you have got this very noticeable pattern in which investors were in essence panicking. And even the most highly rated AA and AAA corporate bonds were not benefiting from the massive amounts of money that were being pumped into the economy by the Federal Reserve at that time. Instead, people were tending to rush into government bonds, 20- and 30-year bonds, in an effort to avoid the zero percent interest rates or near zero that the fed was offering or was pushing down the treasury yields on the 30-day T bills.

So the point being that there was very clear factual evidence that's vivid for anyone to see, and commentators at the time were commenting about, that there was this flight to quality that was taking place, that there was a tremendous amount of nervousness, and that it was part of a broader pattern that helped could explain why the stock market was dropping at that time and why various other markets were acting in the way they were. The LIBOR markets and other markets were going through very unusual gyrations.

The core pattern was you had institutions like Fannie Mae and Freddie Mae that had encountered difficulties. So the seemingly very solid institutions were suddenly becoming apparent that there were risks everywhere. And people were reminded of the fact that even the safest investments still have risks. And the investment community, investors in general, started shifting their attitudes and becoming much less tolerant of even moderate forms of risk, such as the difference between a BAA minus bond versus an A bond. Where normally they would tolerate, they would only pay a small -- expect a small premium to have the riskier bond, during this time period investors were showing less willingness to accept that small premium for greater risk.

So it was a time period, and it is one that we are not necessarily completely out of the woods on, in which we have to be concerned about minimizing the impression that it is risky to invest in Arizona.

Q. Dr. Johnson, what impact will the equity infusions and the improved debt ratio have on the company's FFO to debt ratio?

A. Succinctly stated, it will improve the FFO to debt ratio and it will improve the debt to total capital ratios. The two are closely related.

The FFO to debt ratio, by its very name you can visualize the amount of debt directly affects it. The other variable is funds from operations, which this Commission affects by determining what rates are allowed and which management affects in determining how much expenses they incur. Funds from operations in essence are a cash flow figure that is the net effect of money coming in from customers and money going out to expenses.

The agreement will result in a concentrated effort to improve the balance sheet, to reduce the reliance on debt, to bring in more equity and to borrow less going forward, as well as a general effort to constrain costs and try to improve the FFO to debt ratio through cost controls as well. So I believe those provisions in the agreement are excellent and they are clear benefits to the public as a whole.

Q. The language in the agreement, Dr. Johnson, does not guarantee that the imputed debt ratio will drop to 52 percent. And it doesn't guarantee that the FFO to debt ratio will improve to any specific level. Why are the provisions beneficial if they fall short of an ironclad guarantee?

A. I think we have gotten the attention of management, and that's the first step. There is no question in my mind that management has committed to this program. And there were limitations to what they were willing to sign onto.

The exact language was very carefully crafted and negotiated, but there is no doubt in my mind that they have committed to do it. They understand the importance of it. And if they get an order from this Commission endorsing this or even going farther and saying they are commending the parties for having done this, I think they are going to get a clear signal you need to go out and get some equity, that there is an ultimate long-term quid pro quo there from the Commission that that equity will be supported, that the greater amount of equity will ultimately cost customers money. They are going to pay higher rates through higher income taxes in particular. But if the Commission understands that and agrees to it, and certainly RUCO is saying we understand it and we are agreeing to it, then I think they have got the assurance they need on their part.

You can get into this question, well, is there a mandatory provision. I am reminded as I thought about that and read some of the transcripts about that of, you know, you can have a contractual provision but you always have the right to breach a contract. A lawyer once pointed that out to me. It is just a question what are the damages and are they speculative and are they provable. So you go into any kind of contract, how much better is a written contract than a handshake? Ultimately maybe nothing really matters so much as whether you truly believe the other party is sincerely going to do what they are promising. If you believe they are, then the language is sufficient. And I believe they are.

Beyond that is the fact that APS is a regulated company, has a long-term institutional relationship with this agency. And I think it is not so foolish as to think that it could agree to something like this and then turn around and ignore it and not make its best efforts and not strive to improve the ratios.

The language is what it is in part because there was an understanding that the parties could not commit this Commission. The ability to sustain an FFO to debt ratio in part is a function of, you know, in the future going to be, well, what rate relief is provided, are the funds there.

Similarly, the ability to manage to any one number is limited. The best management can do is strive to try and control costs, to try to keep the funds as high as possible. And I think the commitment is there.

And I think what we have, we have a lot of things in the agreement that, if there is the slightest bit of wavering or doubt in middle management or lower management, somehow what is that agreement, I think there is enough there that it is going to be brought up, no, we cannot renege on this, this was very important to this institution, to APS and to the ACC, we have to do what it takes.

There is going to be tough union negotiations. I suspect there is going to be tough negotiations with suppliers and others that are going to have to feel some pain here in order to achieve what we are looking for, but we think we have got a realistic number, we have got realistic expense reductions, and we have reporting requirements that are going to allow this Commission ultimately to decide did they do this or not, is this smoke and mirrors or really $30 million here.

We are going to be able to ask for documents, and say what was your original budgetary documents in this area, I want to see the actual documents from before the settlement agreement, now let me see what the department is actually spending. There are going to be plenty of ways to audit and verify whether these reductions really take place. And I believe they will because management is on board to do it and they understand how far other parties have gone to try to accommodate them.

I think they are going to try and accommodate us even though it may be painful at times to talk to employees and say you are not getting the raise you expect or talk to the union and say, you know, we have got a difficult time period and we simply can't offer the kind of benefits that we would have liked to have offered in this time period. So there is going to be some tough decisions but I think it will work out ultimately.

Q. You have talked a little bit about some of the performance measures. Were performance measures important to RUCO, and why?

A. They were, and for several reasons. One reason was to, and probably the foremost one, was to try to get away from this situation in which there is a lot of sort of suspicion on both sides, where perhaps management has a tendency to think that all of their problems are due to the unwillingness of this Commission to process rate cases as fast as perhaps the company would like to see them processed or unwillingness of RUCO to agree to rate increases of the magnitude management would like to see, but, conversely, from other parties' points of view, say RUCO's point of view, a suspicion are you really holding your costs down as much as you should be, are you really making the tough decisions.

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 to be monitored. So we are going to move away from rhetoric and away from suspicion and into a world of facts and something that people can honorably sit down in a meeting and discuss and talk about saying, you know, why is this particular number deteriorating, why is this particular ratio worse than it was before, or why is it worse than your peer group, what is your explanation for that. Okay, I have heard your explanation, what are you going to do to try and overcome the factors you have just pointed out. It provides, it is a way of moving away from confusion and suspicion towards one of facts and discussion of what is really going on.

The other thing that it does, I believe, and it is very significant if you look at the actual list of items, is that it provides an avoidance situation in which management is working very hard to manage the company as well as possible, but focused on different goals than what this Commission cares about or different goals than what RUCO cares about. And I think we have avoided that by bringing forth a list. And that list has a lot of things in there that a typical utility and the typical state probably wouldn't think to put on their list of primary goals for management. Things like renewable energy and things like encouraging energy efficiency, those are not the things that the average, you know, middle manager of the average utility would think first and foremost as the primary goal of the company. But by putting it in that list, it becomes clear that's part of what this company is going to be managing towards.

And I think managers want to do their job. They want to do a good job. If they have an agreement what the goals are, I think they are going to strive towards those goals. So I think by expanding the list to include some things that the typical, you know, Harvard business school course on, you know, what are management's goals for a corporation, these are not the things that would normally get listed. But the fact they are there and they have voluntarily agreed to them I think is quite significant.

And it is a subtle difference, but I think important. Yes, you might achieve the same result if this Commission had issued an order demanding that management do certain things and demanding that it follow certain goals. But this was a voluntarily reached agreement. It is something that the company offered to do and was willing to do as part of a package.

And I think ultimately that will help them sell it farther down the line to the actual lower level managers that have to do the job to actually embrace solar and embrace some of these other technologies.

Even if it turns out that it is being bought on the wholesale market or you are paying your customers to provide you with electricity, things that might be a little bit hard to sell in typical corporate culture, the fact that the company has agreed to it and has voluntarily agreed to it as part of this is significant.

It is the difference between a carrot and stick. And I think in many situations humans respond better to carrots. And it is analogous in that something you voluntarily agreed to is easier to embrace and to embed into your culture than something that's being forced on you by the government. And admittedly this Commission has the authority to do these sorts of things but I just think it is better for it to come out of this kind of a process.

MR. POZEFSKY: I appreciate your indulgence, Your Honor. I just have a few more questions.

Q. (BY MR. POZEFSKY) Dr. Johnson, provision 12.2 provides an annual cash incentive should not exceed test year levels unless APS has met its performance measurements. Was this an important provision for RUCO, and why?

A. Yes, it was. It is an extremely targeted rifle shot way of getting management's attention. If for nothing else it was important in the sense will management agree to this provision, are they really seeing the significance of these benchmarks that we are putting into this agreement, do they realize this is significant to us, that their salaries may be on the line, their jobs may be on the line. Because obviously, if they just ignore these benchmarks and do a terrible job and don't achieve any of them and are failing on every front, then this Commission is obviously going to be very unhappy about the situation. But it is a way of getting management's attention, say, look, they have committed not to -- in essence, they are tying their own personal compensation at the highest levels of the company to whether or not lower level people who have to do the job on their behalf are going to do the job. Their own situation of whether they are going to be, you know, in the newspaper as to -- yes, I understand there is a provision theoretically they could still pay themselves big bonuses and just say, you know, notwithstanding this agreement we are going to do it. But we have seen what happened with AIG and other companies that try to do that. That outfall is far too great. So I don't think that the top executives of this company would do that. I think what they are going to do is try very hard to achieve these performance measures, and I think they are going to be able to succeed.

Q. And, Dr. Johnson, the provision on the depreciation expense on the Palo Verde nuclear station and the APS expense reduction commitments, were those also important to RUCO and why?

A. Yes. The two are somewhat different. 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 increase that was ultimately agreed upon was about as far as some of the participants were willing to go. And APS was just having trouble making the numbers work.

They were well below the 11 percent they were hoping actually to earn. When looking at the projections, they were far below that. They were having trouble getting up to the bare minimum they needed to in order to accept it. The provision on 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.

I have forgotten the other provision you asked me.

Q. The APS expense reduction.

A. Yes. That I think I already adequately covered. In essence, it was very important because it was saying, look, we don't want you to treat this as a situation where you have gotten this big check now from customers, go continue to spend like crazy. Quite the opposite, while they were saying it wasn't a big check, the point being to really make the metrics work you also had to work the problem from more than one angle. You need to try to control the costs.

And so that commitment to do it and the ability to audit that commitment and how hard were they working at it, what were they really accomplishing was important. We were trying to create a device somewhat analogous to the way competitive pressures in a downturn, in a recession tends to force efficiencies. And you see a boost in productivity that comes out of a recession. That's one of the good things about recession. There are a lot of bad things, but one of the good things, ultimately it makes companies more efficient. We were trying to create some of that same kind of pressure in a focused way.

Q. And, Dr. Johnson, there has been some concern that the renewable projects, the solar project, the wind facility and the transmission line, are discretionary and not mandatory. How do you respond to that and is that a concern for RUCO?

A. No, I don't think it is a concern for RUCO. The reason they are not mandatory is only the Commission is in a position to make things mandatory.

I don't think the parties felt that it would be appropriate to try to write language in an agreement that effectively would bind this Commission to that degree. This Commission has a role in approving specific projects. It has a role in deciding if a particular project -- if the best response is to an RFP for solar energy or whatever are significantly more costly than natural gas, this Commission ultimately has to decide are you willing to pay that extra cost in order to gain the learning experience and in order to gain the benefits of learning down the learning curve towards that type of energy. It is the Commission's decision ultimately whether to approve the projects.

We believe we have enough of a commitment from APS that they are going to facilitate that process. They are going to do what it takes in terms of soliciting projects, trying to figure out whether certain projects they can build themselves and bring them forward to the Commission. We are not worried that they are going to try to use this language to avoid their commitment. We think the flexibility that's inherent in the language really goes directly to the fact this Commission already has a process for reviewing projects and balancing them. And we were trying to find a way in a rate case with a limited number of participants to effectively bind the company to a commitment of what management was going to try to do without appearing to impinge on the Commission's prerogatives or unfairly affect other parties who may be participants in more generic proceedings.

Q. Dr. Johnson, my last question, you should have before you a letter that I handed you five minutes before you got up to testify. It is a letter from Commissioner Pierce dated, I believe, August 31st, 2009, which asks a couple questions about when in fact the rates should actually go into effect. I wanted to give you an opportunity to explain RUCO's response to those questions.

A. Sure. Let me start with the first one.

I believe it was better to synchronize the PSA reduction with the nonfuel related rate increase to have the two offset each other. I think that sends a more stable price signal to customers. I think that will be better than having rates go down and back up again a month or two later.

If the Commission for whatever reason wants to reduce the natural -- pass through those savings in fuel costs in November or December, but for provisions in the settlement agreement, the obvious solution would be to have the nonfuel rate increase synchronized and have that all take place in November or December instead of January 1st.

In fact, during settlement discussions there was some discussion of having the rate increase provisions take effect in December or even late November. And I think the reason we moved to January 1st was a concern we didn't want to appear to be telling the Commission that you have got to process things faster than you want to. We wanted to be sure the Commission had adequate time to think it through, mull it over, ask all the questions they want to ask.

So I can't speak for the parties. I have no idea whether they would consider it a material provision if the Commission decided to maybe split the difference and make both adjustments the 1st of December instead of January 1st. But from my personal perspective, I don't think it would make much difference. We are talking about a 1 percent net increase for customers happening one month earlier rather than a month later. I don't think it is going to make a tremendous difference one way or another.

MR. POZEFSKY: Thank you, Dr. Johnson.

Thank you, Your Honor; thank you, the parties, for allowing me to ask all those questions. And Dr. Johnson is available for cross.

CALJ FARMER: Okay. It is the noon hour. Let's go ahead and take our lunch break and come back at 1:30. Let me ask the parties, though, before who has questions for this witness.

MR. MUMAW: I have a handful, Your Honor.

CALJ FARMER: All right. Let's come back at 1:30 and we will start with cross-exam.

(TIME NOTED: 12:05 p.m.)

(Colette E. Ross, Certified Reporter, was excused from the proceedings.)

(A recess was taken.)

(The afternoon session resumed at 1:30 p.m., reported by Michele E. Balmer, Certified Reporter.)

CALJ FARMER: Let's go ahead and go back on the record.

Several parties indicated they have cross-examination for this witness, and we'll start with the parties in support of the settlement agreement, with APS first.

MR. MUMAW: Thank you, Your Honor.

CROSS-EXAMINATION

Q. (BY MR. MUMAW) Good afternoon, Dr. Johnson.
A. Good afternoon.
Q. At several times in your direct testimony, you made reference to an 8 percent increase, or something just south of 8 percent. Do you recall that?
A. Yes.
Q. Would you agree that the figure that you cited was inclusive of the interim increase previously granted by the Commission.
A. Yes.
Q. And I think you also alluded to the fact that the non-fuel base rate increase suggested by the settlement in

this case would be marginally offset by a reduction in the power supply adjustment mechanism; is that correct?

A. Yes, it will be.

Q. I think you indicated that you certainly have been a consultant for a great number of years and have appeared in a great number of jurisdictions; is that correct?

A. Yes.

Q. And I take it as part of your business you kind of keep up with rate designs in various parts of the country?

A. In a general way.

Q. Are you aware of whether there have been other electric rate increases in the country this year?

A. There have, but I would be hard-pressed to cite them from memory. But certainly this -- bearing in mind that the 8 percent does include the interim increase, this 8 percent is not out of line with other -- what is happening with other utilities around the country or the west in general.

Q. I think you anticipated, Dr. Johnson, our circumstances in Arizona in that respect, at least, are not unique. Is that fair to say?

A. No. They -- in general, the industry is starting to experience cost pressures that weren't there 5 or 10 years ago where you had many more companies sitting out year after year without having to ask for rate relief.

Q. Let me ask you this, Dr. Johnson. You indicated, and, again, I think in response to a question from counsel, about the use specifically of the change in the depreciation rates at Palo Verde as one of the ways to -- I think your term was to bridge the gap. Do you recall that?

A. Yes.

Q. And you indicated that without that particular device that the company's at least anticipated results were well below not only 11 percent, but well below what they believed would be necessary to attract new equity. Do you recall that?

A. Yes.

Q. Isn't it true that even with the depreciation rate change, even with the pension deferrals, and assuming the company achieves all of the expense reductions called for under the settlement, that the company anticipates that it would still earn well below 11 percent return on equity?

A. All of the data that the company shared with the negotiating parties supported that. There were various projections available. And while we wouldn't necessarily endorse or agree with the exact amount of the projections, in general they seemed consistent with historical experience.

In the last 12 months, Pinnacle West, I think's earnings, and I just checked it this morning, was looking at one way it was being summarized and presented to the investment community, and it was somewhere in the vicinity of 8 percent return on equity for the year ending in June. And that was a continuation of a pattern that's been there for a while where the company has not been earning anywhere near 11 percent. The projections were suggesting they weren't going to earn 11.

We could hope they would earn 11. We couldn't think of a better result than to see the cost cuts and other things be sufficient, but the company wasn't expecting it, and, frankly, we're not expecting it either.

Q. I believe there was also some questioning, Dr. Johnson, about the impact of an equity infusion on the company's FFO-to-debt ratio. Do you recall that?

A. Yes.

Q. And would I be correct in assuming that the reason why, all things being equal, an equity infusion would improve that ratio is because it would either substitute for debt or, in some instances, actually retire debt?

A. Yes.

Q. And referring to the numerator in that particular fraction, I think you testified that the funds from operations is largely a product of both decisions made by this Commission regarding rate levels and efforts by management to contain costs; is that correct?

A. That's correct.

Q. And you would agree, would you not, Dr. Johnson, that an equity infusion is not a substitute for an adequate level of funds from operations?

A. That's correct. But by the same token, trying to solve the FFO-to-debt ratio purely through raising rates is not optimal either.

It was clear, if you look at the debt to total capital ratio, that a contributing factor were the purchased power contracts, which are resulting in an imputed debt level that is around 57 percent. Whereas, the target for -- if you look at Page 25 of my settlement testimony -- let me be very specific here -- there's a table extracted from S&P's published information. And S&P is sort of the most forthcoming with the details of how they go about this. You can see that 57 percent is very close to the high end of the aggressive category, and well in excess of the intermediate.

So the problem is not -- now, the other problem is on the FFO-to-debt on the far left column where it's been running around 16 percent or 18, something like that, which is clearly not very attractive either, but it's in the middle of the range. Whereas, the debt to total capital, it's actually the high end of the range.

So my point is, we looked at this very closely and became convinced that if we could work out an agreement where ratepayers were providing more funds through the rate increase, that would help with the FFO-to-debt problem. But we also felt that part of the problem was with the imputed debt levels that the agencies were looking at and that this Commission doesn't normally look at. It looks at the funding of the rate base as opposed to the funding that the rating agencies are focused on.

Q. And lastly, in that regard, Dr. Johnson, and I think this is consistent with your testimony, with regard to the company, the debt issue is not so much the -- what I would call the stated debt or conventional debt and so forth, but the imputed debt from purchased power contracts and sale and leasebacks and the like of that. Would you agree with that?

A. Yes. And the reason I say that, if you look at the center column, FFO to interest, it's like triangulating a mystery trying to figure out what is going on here. Eventually it becomes clear.

If you look at the center column, the FFO element is common, but what changes is we're focussing only on the interest. And so interest, of course, is a function of the debt that this Commission looks at. And relative to interest FFO, the funds being provided by ratepayers are adequate. The problem is the funds provided by ratepayers are not adequate relative to the total obligations of the firm, including the purchased power contracts.

And I don't want to make it sound like I'm against purchased power. I'm just trying to say this is part of the mystery here. That the agencies view those long-term commitments to buy power in a way very similar to a leaseback of a power plant at 100 percent debt. And they're not including those lease payments or power purchase payments as an interest component, but they are looking at it in terms of the FFO-to-debt, and they're looking at it in terms of the total debt to capital. And in parts of this process, they are imputing the risks associated with those.

And that's not an unreasonable thing for them to do, if you think about it, because they're basically trying to provide ratings for debt holders, and to allow a bank or an insurance company to judge how much risk is there if they lend their money to APS.

And the problem from a debt holder's point of view is purchased power is pretty important, too. So they're going to be right at the front of line wanting to be paid if there's ever a crunch. Their demand to be paid for their power is a high-priority payment, arguably a higher priority than the payment on bond interest.

So a rating agency legitimately needs to think about this and define their way of doing it. And the end result is that I believe that the secret to solving the problem is partly boosting the FFO, and partly backing off the amount of debt such that these metrics move better into line and move farther up this chart.

MR. MUMAW: Thank you, Dr. Johnson. I have no further questions.

CALJ FARMER: Mr. Grant, did you have questions for the witness?

MR. GRANT: I do. Thank you, Judge.

CROSS-EXAMINATION

Q. (BY MR. GRANT) Mr. Johnson, good afternoon.

A. Good afternoon.

Q. It's good to see you. Mike Grant for Arizona Investment Council.

I just wanted to follow on a few areas. Let me go to one that Mr. Mumaw just discussed to a certain extent with you. No, let me do this first.

I get the impression from your discussion with Counsel in the opening, and I don't want to synthesize this too much, but the rating agencies are just less tolerant than they used to be in evaluating and rating companies than certainly before the market events which you described over the past year to 18 months.

Is that a fairly accurate summary of what you said?

A. A little bit of an overstatement. Let me try to draw a slight distinction. I was stating a concern that the agencies may become less tolerant, and there's a reason to be concerned that that could happen given the pressures they're under and the scrutiny they're under because of their failure to adequately evaluate the risks of collateralized debt obligations, securitized mortgages and other products, investment products, that led to the financial crisis of last year, which has had enormous costs to the American economy. They were part and parcel of the problem, and so they're under quite significant scrutiny right now.

I have not seen any indications that they have officially announced they're tightening any of their criteria. What I am suggesting, though, is that we have reason to be concerned that they may be less accommodating in making a waiver of their criteria than they would have been a few years ago.

Q. Stated another way, is it possible that in these circumstances a rating agency might feel more compelled to, if you will, hold fast to the floor of an 18 percent FFO debt than it would have been in the past?

A. Yes. Or put another way, they might be less willing to sort of look the other way if the results of this rate case were very disappointing for APS. In the past, they might have said, well, these things come and go. The Commission will -- you know, if there's a problem here, the Commission will figure it out within a year or two and give them more relief.

They might not want to wait another year or two. Under current circumstances, it seems much less likely that they would do that. They would much more likely go ahead and lower the rating based on an adverse order that they perceive is adverse. Where that line is, no one knows.

I'm not saying that -- I'm not agreeing with your characterization that 17.9 might have dropped the hammer. I'm just trying to suggest that a reaction to what they perceive to be an adverse order might be more severe in the current conditions than it would have been a year or two ago.

Q. Let me move more generally to the market, and you also commented on this in your questioning by Mr. Pozefsky.

Just in general, it seemed to me what you were saying is that the market, and by that I mean investors in the market, are just less risk tolerant than, again, they might otherwise have been but for what we have lived through over the past 12 to 18 months.

A. I think there are indications that, as we sit here today, they are somewhat less tolerant. As we were sitting in the negotiations a few months ago, there was even more of an air of panic or concern or flight from risk than there is today, but we're not out of the woods completely. We could -- it's certainly well within the realm of possibility that market conditions will turn around and dip back down to the kind of conditions we were in in March and February.

So there are indications of some greater aversion to risk currently than there were, say, a year and a half ago; not as severe as they were in the midst of the negotiations in February, March.

Q. Given that, does that make a decision on when to take an equity issue to the market at hopefully precisely the right time more difficult?

A. I think it's always difficult. If I were the company, I would go to the market right now. But if they're not willing to do that, then I would certainly hope the market doesn't turn down on them in the next four months.

Their problem is they've committed to get the equity. If they ever -- you know, if they found themselves in the situation Bank of America was in in February, that's a terrible situation to be in because your stock price starts getting so close to zero it doesn't matter how many shares you issue, you can't raise any substantial amount of capital. So that's just a vivid example of the problem. You can't simply issue lots and lots of stock to solve the problem if investors have lost faith in the company. At some point there's -- you really can't raise the capital in significant amounts.

The timing is left to them. I believe that they will, in fact, issue the 700 million within the next couple of years, and I certainly hope they would. And I would expect them to do a significant chunk of it right after this order, if the order adopts the settlement agreement.

Q. That might be an opportune time to go to market would be after the Commission had adopted this settlement agreement, if indeed they do?

A. Again, the problem with tieing it, that's their decision. They would follow the market for their stock much more closely than I do.

The essence of the problem is they -- from their point of view, they want to issue it at a relatively high price level. There will less dilution of their existing stockholders. They don't have to push as hard to raise the given amount of capital. So they have every incentive to try to time the market, as I'm sure everyone does, but it's impossible to perfectly time the market.

I would note they made the commitment at a time when their stock was far below book value and was at, in fact, a significant low. It has since pulled up from that since the settlement was announced. But they made the commitment at a bad time in the market, and to me that was very significant that management was willing to do that.

Q. Would you agree with me that there's also a ratepayer benefit to maximizing the value of the equity issuance as well?

A. There probably is, but I haven't thought it through. I'm not sure what that benefit would be. Obviously, as long as they raise the capital, ratepayers are provided with the benefits of the capital. I haven't thought it through as to whether there's any particular benefit to ratepayers of raising it with fewer shares than otherwise.

MR. GRANT: Dr. Johnson, that's all I've got. Thank you very much.

CALJ FARMER: Okay. Mr. Crockett.

MR. CROCKETT: Thank you, Your Honor.

CROSS-EXAMINATION

Q. (BY MR. CROCKETT) Good afternoon, Dr. Johnson.

A. Good afternoon.

Q. My name is Webb Crockett. I represent Freeport-McMoRan Copper and Arizonans for Electric Choice & Competition. I just have a few questions that I want to ask you that deals more with the process than the substance of the matters that both Mr. Mumaw and Mr. Grant has questioned you about.

You did participate in the negotiations concerning this settlement agreement, did you not?

A. Yes, I did.

Q. And I think you probably participated pretty much in all of the sessions, did you not?

A. I think so, but over the phone.

Q. And would you classify those as extensive negotiations that were ongoing?

A. Yes, and very detailed and with a lot of active participation.

Q. And are you aware of any parties who may have wanted to participate in those negotiations not being able to participate in them?

A. No. And, in fact, I recall instances in which scheduling efforts were made to try to accommodate as many people as possible. So when people had conflicts, often the schedule was rearranged to try to accommodate those participants.

Q. And are you aware -- you may or may not be aware -- that 22 signatories signed the settlement agreement. Are you aware of that?

A. Yes.

Q. And basically, all who participated in the negotiations did sign the settlement agreement, did they not.

A. Yes.

Q. With one notable exception, who happens to have an issue relating to the APS line extension policy.

Were the participants in those settlement negotiations pretty well representative of all of the body of ratepayers of Arizona Public Service Company?

A. I think we had about as broad a participation as I have ever seen. There were a few interest groups that were not directly represented. There was -- I don't recall anybody speaking up on behalf of churches. That happens that that was a concern that other participants spoke up about and it was dealt with.

In terms of small business, RUCO sort of stood in lieu of being a representative of them in some sense and many of their concerns would be shared by the small business group, but they did not directly represent small businesses. And the Staff, similarly, wouldn't be concerned about and thinking about those people who were not directly in the room.

But certainly there was an unusually diverse mix of interests being directly represented in terms of even low income consumers were represented. Those who are interested in more energy efficiency were represented and so forth.

Q. In your experience in participating in rate cases around the country, have you experienced such a situation with reference to negotiating settlement agreements?

A. No. Much more typically the negotiation would be either between two or three parties, but major parties. So, for example, perhaps the large industrial users, the public interest representative, and the utility, or maybe one or two more, but that would be about it. It would be very rare to have this number of intervenors and to have that many intervenors who were willing to and had the patience and the resources to sit through hour after hour, day after day of negotiations as happened in this case.

Q. When negotiations were started with the variety of different interests represented in those negotiations, were you of the opinion that it would be possible to bring about a settlement agreement among all of the parties?

A. I was not expecting a comprehensive settlement. I thought there was a fairly good chance that at least one or two of the major parties would settle with the company and there would be a bunch of other parties unhappy and not signing on. I think that was a much more likely outcome.

We have seen that in RUCO's case, in fact, occasionally has not participated or has not agreed to the final settlement because they were not satisfied with the terms. To have, say, one of the environmentally oriented groups or perhaps the large industrials or Coke or some other specific interest saying, look, I'm here for a reason, and it's fine that you guys settled this issue about rate of return, but you haven't solved my problem of interruptible rates, or whatever it might have been, would be a much more likely outcome.

So I think to get this sort of comprehensive settlement took a lot of extra effort, it was a little bit surprising, but I think it was worthwhile.

Q. You probably observed a lot of give and take among the parties during the settlement negotiations, did you not?

A. Yes.

Q. Also during the settlement negotiations, would you agree that the negotiating parties knew that the settlement had to be in the general public interest?

A. Yes.

Q. And for that reason, probably some parties were willing to give in areas where they otherwise would not have been willing to give if this thing had gone to -- if this case had gone to a litigated proceeding before the Commission; is that correct?

A. Yes. I think there was specific issues where people who might normally just vehemently be opposed to a particular provision weren't so vehement, or fairly early on signalled a willingness to accept something because they recognized that would be attractive to the Commission, that that provision clearly showed a benefit to people beyond the room or people who were typically underrepresented.

Q. Would I be correct in stating that there was a general philosophy among the parties to the settlement negotiations that they ought to be bringing about a settlement agreement that would be in the broad public interest?

A. Yes, very much so.

Q. And RUCO does support this settlement agreement as being in the interest of the public, does it not?

A. Yes.

MR. CROCKETT: Thank you, Dr. Johnson. That's all I have to say.

CALJ FARMER: Mr. Robertson.

MR. ROBERTSON: Thank you, Your Honor.

CROSS-EXAMINATION

Q. (BY MR. ROBERTSON) Good afternoon, Dr. Johnson.

A. Good afternoon.

Q. My name is Larry Robertson. I'm appearing in this proceeding on behalf of the Mesquite Group, whose members are members and participants of the merchant generator community here in Arizona.

I have, as I have previously indicated on the record, provided your counsel and you with copies of the series of questions I intended to propose and will pose to you this afternoon.

But before I do that, I would like to follow up on what you and Mr. Crockett were just discussing and, on behalf of my clients and myself, publicly acknowledge on the record and express our appreciation for what we felt was a very substantial contribution to the settlement process that was made by you; Mr. Ralph Smith, the Commission Staff's consultant; and Kevin Higgins, Mr. Crockett's clients' consultant.

You alluded a moment ago to how a number of varying interests that normally might not be embraced within a settlement agreement were captured within this one. And in my opinion, one of the major reasons is because you and Mr. Smith and Mr. Higgins were willing, literally on the run, to crunch the numbers and assist in the analyses of various issues and propose resolution of those issues as they came up in real-time during the course of our various negotiating sessions. And I think that played a major role in allowing the process to retain its momentum and move forward to a successful conclusion.

So again, on behalf of Mesquite Group and myself, I would like to express our appreciation to you.

A. Thank you.

Q. Against that background, I'm going to start from my list of questions. And in each instance, I will give you a reference to your prepared direct testimony that was submitted in support of the settlement agreement in case you would like to refer to that portion of your testimony, but hopefully my lead-in to the question will give you the context.

I'll start with Page 8, Lines 4 through 7. In this area of your prepared direct testimony, you refer to how the settlement agreement, quote, establishes specific operational and financial performance measures for APS, close quote, which would relate to, quote, important goals, close quote, of the settlement agreement.

One of those performance measures pertains to, quote, APS's level of major capital expenditures and its consideration of available alternatives in connection with such capital expenditures for generation facilities, close quote, does it not?

A. Yes.

Q. Would you agree that that performance measure is intended to provide the Commission and interested persons with insight into whether APS has made intelligent decisions in connection with major capital expenditures for generation resources?

A. Yes.

Q. I'm going to move now to Page 21, Lines 8 through 16 of your prepared direct testimony. In this area of your prepared direct testimony, you discuss how the prospect of APS, quote, losing access to credit markets on favorable terms during these turbulent times, close quote, influenced RUCO to revise its original position of, quote, strict reliance on the historical test year, close quote, in this rate case.

A. Yes.

Q. Would you agree that the loss of access to credit markets on favorable terms to which you refer could also include APS's loss of access in connection with APS's role as a participant and purchaser in the competitive wholesale power market?

A. There's no question that if APS were downgraded, it would be -- it would have negative consequences for the wholesale market since APS is a major participant in that market. Counterparties would be either less willing to deal with APS, or if they had no choice but to deal APS and they want to deal with APS, their investors in turn may be less willing to provide them with funding. So I think projects may have difficulty going forward if it's backed up by a contract from a company whose credit itself has become questionable.

So the ability to fund, say, a solar project that an entrepreneurial group were putting together and needing to be able to go out and get dollars of capital to assemble that project based in part on the assurance of being able to sell the power to APS, well, if APS's ability to fulfil that contract and write the check every month starts becoming no longer sort of taken for granted but becoming a matter of concern, then the investment bankers or banks that would fund the entrepreneurial venture might be unwilling to do so. So the consequences are potentially significant for the wholesale market.

Q. And similarly, with regard to existing merchant generator plants that were already constructed and in operation, if APS was competing with another utility to purchase capacity and output from that plant, APS's having less favorable credit ratings could be an adverse impact against APS's ability to successfully compete for that capacity and output, could it not?

A. It could in that the likelihood of that becomes much more significant if they're no longer investment grade. I mean, if the merchant plant is looking at an offer from Nevada Power or Public Service of Colorado or whomever, versus APS, and there's a slight difference in bond rating but they're both investment grade, it's much more likely that other factors like line losses and location relative to the merchant plant, other things are just totally swapped.

But just sitting there saying, I don't even know that I want APS to be in my group to be considered, considering that I'm not so sure they're going to pay me, and I'm not so sure how am I supposed to explain it to my investment bankers why did I sell to them if they ever had problems, it could become an issue where APS would find itself having trouble competing against its sister utilities in the region.

Q. Okay. Let's turn now to Page 24, Lines 17 to 21 of your prepared direct testimony. In this area you attribute part of APS's chronic, quote, weak rating, close quote, to the fact that APS has some long-term purchased power contracts, quote, which are interpreted by the credit rating agencies in a similar manner to debt, close quote.

A. Yes.

Q. However, in making this observation, you do not intend to suggest that APS's credit metrics would necessarily have been better if they issued long-term debt to acquire or substitute for the power resources represented by the purchased power agreements, do you?

A. I wasn't suggesting that, and that wouldn't be very likely. Typically, if APS were building its own project, it would use a balanced mix of debt and equity. And that's precisely the point, that if it weren't relying on purchased power, it would likely be paying more income taxes and basically having more equity to fund the plants that it would have built itself. And when building those plants, it's unlikely they would have used 100 percent debt, so it's unlikely that you would get the sort of FFO-to-debt in these other metrics that we're seeing here.

It's a direct function of the decision by the company and the Commission to try to encourage competition and to diversify away from all self-owned plants. That there are these consequences for the financing of the company that I don't think have been adequately thought through. And it's becoming clear in this case that those have mounted to the point where some compensation needs to be taking place. In essence, you have to have some additional equity in your capital structure to help balance the purchased power contracts.

Q. And the company in that regard needs to be in a position to successfully issue that equity in order to achieve that balance, correct?

A. Yes.

Q. In that regard, won't the infusion of an additional 700 million in common equity and the average annual reductions of 30 million in expenses contemplated by the settlement agreement have the effect of diminishing the relative role which that imputed debt attributable to long-term purchased power agreements would perform in relation to APS's overall credit metrics?

A. I'm not quite sure I understand your question.

Q. Let me try rephrasing a different way.

In your opinion, what effect will the additional equity infusion contemplated by the settlement agreement, coupled with the contemplated reduction in annual expenses on the order of $30 million a year, have on APS's FFO-to-debt ratio?

A. Both of those -- when they take place, both of those will help improve the FFO-to-debt ratio. No question about that.

And in turn, the only other way to improve the FFO-to-debt ratio under this time period would be to issue less debt or find some other -- you know, enter into fewer purchased power contracts. Do other things to try to change the denominator in the FFO-to-debt ratio.

The equity infusion tends to make it feasible to issue less debt or even to retire debt to a small extent, but in and of itself isn't reducing debt. The need for continued financing will be there over the next few years. The equity alone, unless they issue far more than the 700 million, equity alone would not be sufficient to cover all of the financing needs over the next four or five years by any means.

So they're going to have to deal with more than just the equity. The equity is a major step in the right direction, and they've committed to rebalancing capital structure. So one way or another, they're committed to the end result that's needed, which is to get the capital structure a bit less leveraged and more conservative.

Q. I may come back to that area in a moment, but let's move on to Page 26, Lines 12 through 22 of your prepared direct testimony.

In this area you discuss how, quote, a further deterioration in APS's financial metrics could make it very difficult, if not impossible, for APS to acquire the funds it needs to finance its construction program.

Would you agree that such a deterioration in APS's creditworthiness could also adversely impact the terms and conditions on which APS could obtain credit, and perhaps its ability to obtain credit at all, in connection with its role as a participant and purchaser in the competitive wholesale power market?

A. Yes. So if, for example, you're asking me, well, don't worry about it, you don't need to finance a construction program, let someone else build everything and just rent it from them, I don't think that's going to work. The credit concern would also apply to any effort to rent property from someone else or to purchase power from somebody who builds a plant to serve your needs.

So to the extent that the need is actually there, whether they build it themselves, lease it from someone else, or purchase the service out of that plant, under any number of scenarios the core issue is: Are you going to have the cash flow available to pay the people who ultimately put up the capital?

So if it's a merchant plant, they ultimately are raising capital as well. And even if it's, you know, a merchant that has very deep pockets and doesn't need to go out into the market, they're going to say, well, why should I be building a plant for APS when I can build a plant for Pacificorp or somebody else who has better prospects from my point of view of paying me, and I'm not going to have the hassle of dealing with all of the problems if I shut down the contract and start sending the power somewhere else and I've got a big lawsuit because APS is, you know, screaming because they are expecting the power and I'm not giving it to them, I'm giving it to somebody else. It's a hassle they're not going to deal with. So the core problem is there regardless of whether they self-build or whether they buy from someone else.

Q. Let me build upon that last response with an additional question that was not on the list, Dr. Johnson.

The record in this proceeding indicates that looking out into the future, as a part of its effort to comply with its obligations under the Commission's Renewable Energy Standards, APS may be looking at one or more utility-scale solar generating facilities that it may or may not own.

Wouldn't the very sort of considerations that you have been testifying about with regard to its ability to obtain credit or finance projects on its own that was against the background of conventional generation resources also be applicable to those larger scale solar facilities as well?

A. Well, not only would they also be, but I think you could argue they are even more of a concern because a solar project reminds me a little bit of a nuclear project. There are good things about the cost function in terms of you have got -- once you build it, you have got stability for many, many years and you're not having to worry about the natural gas market or the coal market.

On the other hand, you've got to finance a larger amount because a larger proportion of the total cost of the project is the fixed cost that you pay day one to build it. And so the ability to finance a project on attractive terms, reasonable cost for your capital you're putting in, is a greater concern for a nuclear project or a solar project than it would be for, say, a natural gas project.

The most extreme case, something like that, of combined cycle or combustion turbine, the capital costs are relatively small compared to those other technologies, so the need to finance and all of those concerns are less, but you have a different risk you're dealing with, which is the risk of escalating natural gas prices 5, 10, 15, 20 years from now.

Q. Okay. Let's turn to Page 31, Lines 12 through 14 of your prepared direct testimony. In this area you discuss how the cost reductions provided for in the settlement agreement will help APS to maintain or improve its bond ratings. I believe some of your previous answers to my questions may have answered this one, but I'll pose the question anyway.

Would you agree that, in turn, those same cost reductions would have a collateral benefit of helping APS to maintain or enhance its creditworthiness as a participant and purchaser in the competitive wholesale power market?

A. Yes.

Q. And finally, with reference to Page 32, Lines 2 to 5 of your prepared direct testimony, in this area you discuss how the cost control and increased efficiency measures contemplated by the settlement agreement could motivate APS, quote, to negotiate better pricing from suppliers, close quote.

Would you agree that improving APS's creditworthiness as a result of the settlement agreement also could induce vendors to offer better prices and terms to APS than otherwise might be the case?

A. Certainly it's a possibility. I think the greater concern is sort of the flip side. That failing to take these measures, if their creditworthiness were to decline, and it's going to be a big headline in every newspaper if that happens, and, again, it's going to be one of the rare instances where a utility drops out of the investment grade, so it's newsworthy. You know, even the smallest vendors are going to sort of be aware of it and start thinking, well, you know, maybe I shouldn't be granting those relatively generous terms that I have had of 60-day credit, or whatever, because I have always just assumed I'm going to get paid so, you know, why not cut them a good deal to try to get the business. Even smaller vendors may become nervous and want a little higher prices or be a little less aggressive in cutting their prices.

So I guess I'm a little more concerned on the flip side that were they to lose the bond rating, there might be adverse repercussions that would show up in operating expenses that would be very hard to trace back to the decision not to provide the regulatory support but were real -- a real reality that ought to be considered in evaluating the settlement and evaluating whether this rate increase is in the public interest.

Q. Dr. Johnson, one last area with a question or two. Mr. Crockett established through his cross-examination of you that you were intimately involved in the settlement negotiations throughout.

I gather it would be fair to say that you have a good and a comprehensive knowledge of the settlement agreement as an entire document, do you not?

A. Yes.

Q. In your opinion, do you believe that Commission approval of the settlement agreement as an entire package is crucial to placing APS in a financial position where it will be able to discharge the numerous obligations it has agreed to undertake under the settlement agreement?

A. I would rather not use the worth crucial, but I would say I think it would be wise for the Commission to adopt the settlement agreement.

And to the extent there have been various concerns expressed through questions that I have read in the transcript, in almost every case, perhaps every case, I think that concern can much more effectively be accomplished through language in the Commission's order in which in adopting the settlement the Commission expresses as a matter of policy either additional expectations for the future as to how it will scrutinize things.

If it feels certain language is vague, then adopt the agreement as it is, but make clear that in its review role in reviewing reports and the like, it's going to take a tough stance or it's interpreting language in a certain way.

To the extent, for example, the Commission believes that the commitment to renewable projects is not strong enough, the Commission can easily solve that by adopting the settlement as is and expressing its intent to effectuate the terms of the agreement through the other dockets that are under this Commission's control.

So I think the Commission has ample opportunity through the language of its order to clarify its position and to go beyond the settlement in appropriate ways where the evidence supports that, and without undermining the settlement and without creating a situation in which any of the parties would feel compelled to ask for rehearing.

MR. ROBERTSON: Dr. Johnson, thank you. That's all I have. I wish you a safe trip back home.

THE WITNESS: Thank you.

CALJ FARMER: Okay. Questions from Staff or any other party in support of the settlement agreement?

(No response.)

CALJ FARMER: All right. Ms. Pecora?

MS. WYLLIE-PECORA: Thank you, Your Honor. I just have one question.

CROSS-EXAMINATION

Q. (BY MS. WYLLIE-PECORA) At some point I heard you say that this is a growth state. What criteria do you look at to be a growth state?

A. I think it shows up in every metric over a 50-year period. If you were to look at population growth, if you looked at number of households, if you looked at total number of buildings, total number of square feet, certainly if you looked at the kilowatt hours of consumption, Florida, Arizona, to some degree Texas, parts of California, are sort of our classic examples of growth states. I think that's a fair term that most people agree to. That's not to say they're growing right this minute, just that historically Arizona has been a growth state.

Q. So compared to Delaware or Connecticut or someplace like that, it's a growth state here?

A. Right. Compared to probably Florida and more of the 50 states. Even if you take the extreme cases like Michigan, or whatever, where people are perhaps leaving, it's just it has tended to grow faster. You see it in the census every 10 years. You see it in the reapportionment of congress that states like Arizona every decade or two pick up another congressman and things like that.

MS. WYLLIE-PECORA: Okay, thank you. That's all, Your Honor.

EXAMINATION

Q. (BY CALJ FARMER) I have some questions for you, sir, from Commissioners.

A. Okay.

Q. I'll start with some from Commissioner Newman. Commissioner Newman says that he understands that APS wants to put fuel costs that were in the power supply adjustor into base rates. And his question is, is it more difficult to break out fuel costs when they are included with all other costs, and why is this good for ratepayers?

A. I think from a consumer's point of view in terms of information on the bill, having a line item for fuel and purchased power has certain disclosure attributes that are something that if the Commissioner is interested in pursuing that, I would not recommend against pursuing it. I would certainly recommend against taking action right this minute in this particular proceeding, because it's a concept that would apply to other utilities under their jurisdiction. And I think the right way to look at a broad policy issue like that is in a generic proceeding in which the other utilities have a chance to participate. So that's one side of it.

And certainly given that perspective, to answer the question narrowly, it's a little bit more difficult for a consumer to figure out how much of their bill is attributable to fuel and purchased power when those costs are routinely rolled into a base rate every few years than if they were distinct and separate. It's a little bit analogous to the issue that's been raised about DSM costs and whether perhaps those should be in their entirety split out in a line item rather than a portion being reported separately.

As to the other side, and it's not clear which side he was most interested in and if he wanted me to explore all of it, I'll briefly mention another side of the question is why might it be important to do what is happening in the settlement. And the answer is because we want continuity of policy from the Commission. It's very important that when the Commission changes policy, it does so carefully and deliberately and thinks through all of the consequences as best it can.

In this particular area, there's some very significant consequences for the 90/10 sharing. RUCO supports the 90/10 sharing, and I would be glad to explain why, but in summary it provides an incentive for management to purchase power and to purchase fuel as cost effectively as possible within the practical limits of a regulatory scheme.

That if you were to set up a system in which 10 percent of fuel and purchased power costs would forever more be absorbed by shareholders, the company would eventually go bankrupt. You simply can't do that. It's not practical. The whole system of regulation is based on the premise that over time and on average, customers will reimburse the utility for its costs and give it a chance to earn a fair return. And to take a major item like fuel and purchased power and say, well, you're only going to recover 90 percent of that just wouldn't work. The system would break down. So it's not really a viable option.

When we talk about a 90/10 sharing, what we're really talking about is 10 percent at the margin of decision-making. When they're making decisions day-to-day on this contract or that and using this vendor or that, and whether they hedge in this manner or that manner, those are the types of decisions that they have some real control over, and they can have a real impact on consumers.

And having 10 -- when they're looking at each one of those decisions and recognize that 10 percent -- if I mess up and I make the wrong decision here, 10 percent of my mistake is going to be borne in my earnings per share that are affecting my personal compensation, or whether or not the board keeps my contract or I stay with this company, et cetera, so this is real money and it matters for at least a couple of years, and that's kind of the way it works.

To full circle back to his question, the way it works is eventually, after a couple of years, if you had a really long-term arrangement, say, a coal contract that's 20 years, well, it's 10 percent the first couple of years, and then eventually -- because unless the Commission steps in and says this was imprudent and disallows permanently a portion of the contract, a portion goes into base rates and eventually the 90/10 sharing stops.

So the point is, the 90/10 is a good policy. And part of the reason it works is it tends to be focused on the immediate decisions management is making, and there's time for review by the Commission for prudence and other concerns. And as long as it's not a long-term concern, there was not imprudence, then eventually we step in and customers will reimburse the full 100 percent.

That's the theory behind it, it's a sound theory, and I would urge the Commission not to change it quickly. If you're thinking about changing it, at least look at it carefully with an opportunity for all of the parties to explain the options, and there are other ways the underlying concerns could be solved.

Q. So would you agree or disagree that eliminating the 90/10 split for the PSA places more risk on ratepayers?

A. I think ultimately it puts more risk on ratepayers because -- maybe not the way he's thinking -- because you're in essence going to a cost plus contract type arrangement where everything is a dollar for dollar passthrough. That's the way I'm hearing it. When you say getting rid of the 90/10, it sounds like you're going to 100 percent passthrough of all costs, good or bad, good, bad, and indifferent, unless they're specifically found out and disallowed.

And I think that's ultimately more risk for customers than one in which you have a system where when costs are rising the company has to absorb some of it; when costs are coming down, the company -- it sort of averages out. The company gets to keep some of the money and help cancel out some of the earlier losses.

But in each case, the part that they can control, the decision to buy from this vendor or that one on a 30-day contract or a 210-day contract, those kinds of decisions they can make, 10 percent of that decision is affecting their earnings per share and it's not simply being passed through. So I think that's a good system and I would urge you not to change it.

Q. Okay. Can you explain how the 90/10 sharing provision works in the following situations. The first situation: APS underestimates its fuel costs for the year by $1 million. What happens to that $1 million?

A. I'm not sure what the Commissioner is asking. I don't know that the estimates, per se, are critical. What is critical is that the mechanism passes through 90 percent of the change in fuel costs.

So if the change is upward, then 10 percent of the increased cost is not immediately passed through. It's not initially passed through. If the cost is coming down, then it's the other direction that there's 10 percent that stockholders benefit from.

But I'm not clear on the part about the estimating process, how that fits in. It may just be because I'm not sufficiently familiar with some of the nuances of the specific mechanism being used.

Q. Continuing with Commissioner Newman's questions.

APS is asking ratepayers to give it a rate increase because it is underearning, yet when APS overearns it keeps the money. Can you explain why this is fair?

A. Yes. First of all, at least in practical reality, APS hasn't overearned very much lately, so there's not a lot of offset going in that direction.

But if you look more broadly at utilities around the country in general and the system of regulation we have, there are some companies in some states that have overearned for three, four, five, six, years in a row, and they have gotten the benefit of that overearning.

The reason the system is fair is because it's a balanced system. It's not skewed one way or the other. There are mechanisms available for commissions to step in and have a show cause for lowering rates if it appears that the overearning will continue. And that is analogous to and going the other way from the mechanism available to the company to request a rate increase if they're underearning.

There's some differences. Certainly one difference is that the companies can ask for rate increases as often as they want. They could come in every year. They could have -- a typical state, there's no rule that would prevent a company from filing right in the middle of an existing rate case.

Now, obviously, that may kind of hurt their PR. The Commission may say, gosh, we're just still figuring out what to do with that one you filed a year and a half ago, and now you have got another one you're asking me to look at? And you say, yes, sir, I'm asking you to look at it again because I can see you're not going to be -- it's at least four or five more months before you issue an order, and I'm ready to file.

I mean, in most states, I think Arizona would be one, there's no rule that technically says that you can't do that. On the other hand, in practical realities, it's pretty rare. Usually they wait, and so the commission has some control over the timing of rate increases. They decide how long it takes to process the case. And while it's pending, a utility rarely can -- rarely would choose to request another increase.

So in that sense there's some reciprocity here, because for -- going the other way, from a ratepayers' point of view, reductions won't take place until Commission action takes place.

So in both cases, whether it's overearning or underearning, the Commission is ultimately at the driver's wheel in deciding how soon to correct the problem if it's perceived to be a problem.

Q. What is the impact of continuing the stay-out provision for another two years?

A. If the Commissioner is suggesting two more years beyond the two in the agreement, I believe that would be a material change and you would have multiple parties asking for rehearing and basically saying the settlement is off; now we're into a litigation mode. And beyond that, I think you would be looking at a very negative reaction on Wall Street.

So again, if we're talking -- if there's no further change, if it's this number of dollars with these provisions and we're asking the company to not come in for four years rather than two years, I would think that would be something that would have a negative impact on Wall Street and it would have a -- would be considered a material change by multiple parties.

Q. Please explain the FFO-to-debt ratio in detail and explain clearly what it means to have an FFO-to-debt ratio of 18 to 28 percent.

A. Well, the FFO-to-debt is fairly straightforward. First let me see if I can find that page. I was looking at it earlier.

MR. POZEFSKY: Your Honor, I think the mic went off.

THE WITNESS: I just stepped away. I'm sorry.

Page 25. It's a ratio. The top half of the ratio, the numerator, is funds from operations. And I don't have in front of me the exact definition of that, but, in essence, it is similar to income adjusted on a cash flow basis. So it's a cash flow type of measure of income. In essence, it's revenues minus -- cash revenues minus cash expenses is the essence of what is driving funds from operations. And it would exclude cash from, say, selling off cars that you no longer needed, or selling off office buildings, or some other funds from nonoperating activities. So that's what the "O" part is.

The denominator is a measure of debt. And it's unclear in the case of two of the agencies precisely how they're measuring debt. But in the case of S&P, which is the one that has the lowest rating, they make it very clear what they're doing. They have -- and it's clear that they are imputing in there, in addition to bond debt or commercial paper that a utility might have, they are also imputing some measure of a sort of a capitalized equivalent of purchased power contracts, and some measure of sort of a capitalized equivalent of things like the Palo Verde leaseback that this company has entered into.

So if you try to get -- you know, sort of fund some of your paper, some of your capital through things that are not called debt but have some of the same characteristics of debt, then the rating agency may classify that as debt or may try to calculate a dollar equivalent.

So in the case of a purchased power agreement, you may be agreeing only to pay for power as and when delivered at so many cents per kilowatt hour, but because you're committed to buy it whether you need that particular power or not, you're basically going to lower your own generation, cut back your own units, and continue to pay this vendor. They're viewing that as similar to debt in that it's a fixed obligation that you're obligated to comply with and it has characteristics similar to debt. So that is part of the denominator.

The particular percentages just happen to come out the way they do. It relates back to the industry and experience of the rating agencies as they look at different utilities and view: How can I compare a utility in Arizona with a utility in Connecticut?

There may be all sorts of things that are hard to compare that are the seasonality, all kinds of things are different. But there are certain things that are pretty similar, and funds from operations is sort of a universal. Debt is a universal. Interest payments are universal.

So that's why they have these ratios that allows them to make clear to their customers who buy these ratings how they're going about it and how they're comparing different utilities. So why would you give this Connecticut utility an A-rating and give this Arizona utility a Baa-minus rating? It's going to show up in these sort of common denominators or comparability metrics. And that's where the FFO-to-debt fits in. It's one of the major metrics that they rely on and they publish.

Q. (BY CALJ FARMER) Moving on to his next question, regulatory lag is an inherent part of traditional ratemaking. Commissioner Newman says that he understands that only 15 states allow future test years so that utilities can collect more funds up front. And he has several questions, which I'll read to you and you can just address them in your answer.

How does this serve ratepayers' interests over shareholders' interests? If APS gets more money up front, what incentive does APS have to spend money wisely, and would competition better serve ratepayers by lowering costs?

A. I think there's really several elements to that question. I may ask you to repeat it after I give a partial answer to that. I'm only going to be able to remember part it.

But part of what he seems to be probing is this issue of historic versus future test year. So since he's not here and can't shut me down if I'm talking about the wrong thing, I'm going to try to respond as best I can to each piece to make sure I don't miss something.

Yes, Arizona is a historic test year oriented Commission, and it is in good company in that regard. I don't know the exact figure, but 15 sounds about right.

The majority of states still use it, and I believe it is generally preferred for some basic reasons. It is less controversial and less litigious. There's less subjectivity to it, because you have hard numbers, hard data that you can look at, and it's not a matter of so much opinion. Whereas, in a projected test year, everything is a matter of opinion. I'm projecting that I think this is going to happen; I think that's going to happen.

Another advantage of it from the perspective of someone like RUCO is that it would be very difficult and costly to try to compete on a level playing field with presenting evidence in that projected test year environment, because the company has teams of people who do projections routinely for their own internal planning purposes. And so as an output of that, they can put a witness on the stand who can have a very well thought through and presented projection with relatively little effort. Whereas, for someone like RUCO, they have to hire someone like myself who has to build an econometric model of the company and has to try to analyze all of the causative factors and --

COURT REPORTER: I'm sorry. If you could slow down a little bit.

THE WITNESS: Sure. Someone like RUCO or the

Commission Staff would probably, in reality, have to hire someone like myself to build an econometric model to try to model the company. The other alternative is to put someone on that's an analyst who tends to pick apart details of the projection and find flaws in it.

Either way, it tends to skew the process in favor of the utility and makes it harder for the Commission to judge the merits of the company's case. Because you have people in the room complaining about the projections, but they don't have a lot of good, solid basis for saying that this exact dollar amount is wrong here unless they can afford to build a model or something of that sort.

But there's another aspect to it that's here, which is that all historic test year jurisdictions are not identical. So you can process a historic test year case in nine months, that is in Florida the statute requires, and I think it still requires. The commission has no choice. A case is filed, you've got nine months to make your decision. You take that nine months and you back it up and you say, we'll give ourselves 45 days to deliberate after the close of the hearing, 30 days to deliberate, and out the door goes our decision. We give eight months to the parties to assemble the evidence and put on a hearing. We allow, say, three weeks for the hearing process or two weeks, because some of those hearings in Florida are very lengthy, and just everything starts being jammed together, but you get it done in nine months.

When you do that, the difference between a historic and a projected test year is not as extreme because everything is so compressed. The decision is out in less than a year from -- or approximately a year from the end of the test year.

Another thing that some historic jurisdictions will do is a partially projected, partially historic filing that allows the parties to start looking at what is really going on. Such and such a plan is being finished, they're asking for a change in PPO benefits, a lot of different things that you can figure out.

And then they have an update in which they replace every bit of the projections with actual historic data before the intervenors have to file their testimony before the hearing. So you're no longer really wasting time worrying about whether the projection is accurate or not. You're using it as a placeholder to give you time to hire consultants, to organize your internal staff, to do all of the things that you have to do in a rate case. You're not too worried about the projections because you know they're all going to be replaced with historic data before you go to hearing anyway. So that's a way of compressing the timeline into, say, a year instead of 18 to 24 months. That may happen.

There's various things, and different states take different amounts of time. But the amount of time that elapses from the test year to the date on which the rates go in effect is very significant. And if it's a year, that's significantly different issues than if it's two years. The longer that gap, the more the pressures build to say, well, why don't we go to a projected test year, or why don't we do all sorts of adjustments that go beyond the test year and let's, you know, cherry pick this plant item and that wage contract and so forth, kind of things that were in the company's filing in this case.

Those sorts of adjustments become more popular and used more extensively in states which have a lengthy delay from the end of the test year until the decision is made, and that has its own down sides. Those are themselves subjective and controversial.

So in terms of the original question, if you would read it to me, and I'll try to be very brief and I'll make sure if there's anything else I missed, I'll cover it. He's not here. I want to make sure I didn't answer the wrong question.

Q. (BY CALJ FARMER) How does the regulatory lag serve ratepayers' interests over shareholders' interests?

A. A short amount of regulatory lag is clearly in the interest of ratepayers because it creates an incentive for companies to manage efficiently. They know that they can't simply write bigger and bigger checks for anything they want to, because there's going to be a period, even if it's a test year in which they're writing the checks, there's a period in which they're having to absorb that cost.

But I don't believe that it serves ratepayer interests to have two or three years of regulatory lag. You get that efficiency gain with even nine months or a year of regulatory lag. And so going beyond that to 18 months, two years, three years of regulatory lag, I don't really believe is in the consumer interest, because ultimately there's sort of the unintended consequences in the next case. You end up having requests for more and more adjustments and you're spending more and more time trying to decide whether to adjust the test year 25 different ways instead of two or three simple ways.

Q. And would competition better serve ratepayers by lowering costs?

A. I believe that competition has benefits. And where it can be introduced without losing the benefits of regulation, I think it's worth considering.

The experience to date has not been very attractive where we've tried to completely replace regulation with competition. Certainly, California has had its share of problems. I think some other states have had problems as well. And I think there's quite properly been a pulling back and saying we need to go slow in trying to figure this out.

I think, perhaps, currently what is happening in Arizona is pretty close to the right mix where they have a regulated utility that's pretty much responsible for distribution and transmission. It stands ready to invest in generating plants where the market isn't providing adequate alternatives, but it's also been encouraged to and it seems to be willing to let others build projects rather than doing it itself where they can do it cost effectively.

So that attempt at mixture where there's some competition seems to be worthwhile. Trying to go beyond that and say, well, we're going to try to have a competitive process to handle distribution, for example, I think there's really very few observers of the industry and knowledgeable people who would urge anyone to try that. I don't think anyone has figured out how to make it work mechanically. Even if you were to allow two sets of wires coming down the poles, there's really a limit. I doubt you could -- and you might be able to run somebody else's wires down a different side of the street, and then we would have twice as much visual pollution to deal with and it would be pretty costly.

I don't know anybody who seriously believes that we can completely do away with regulation and go purely with competition.

Q. And finally, the last question from Commissioner Newman, you may not have all of this information, but if I read it at least it will also put the company on alert to maybe have somebody who can testify about it.

Staff regulatory consultant Ralph Smith submitted testimony that APS's cash flow problems are from low customer growth. He was looking for APS's customer growth as both a percentage of total sales, a percentage of residential sales, and the dollar amount per year for the years 2008, '7, '6, '5, '4, '3, '2, and '1.

Have you or do you know whether APS has modeled what its cash flow would look like in a no growth or declining sales scenario?

A. I think in my original prefiled direct testimony I might have had a little bit of discussion on those historic numbers. I don't recall. I know looking at them in work papers, I recall that distinctly, but I can't remember as to how much of that detail actually made its way into the testimony and exhibits.

But the easiest solution to that would be to have the company provide an exhibit in the format that the Commissioner wants where he can see the numbers. So even if it's buried somewhere in my exhibit, it can't hurt to get another set of numbers.

If it's in my exhibit, it would be in the section where I was dealing with the attrition and trying to look at some of the underlying factors, and I know I looked at growth patterns as part of that.

What you would find, first of all, is that it has been growing as measured in both kilowatt hours and customer count or meter count, different ways you can measure customers. And I think there's even been some growth in usage per customer, although that's slowed down as energy efficiency has become more of an option for people. So there's been growth.

The one thing that's very important to understand here, though, is that -- it might otherwise seem like a logical disconnect -- is that in one sense growth is part of the problem when it's high growth, and in another sense growth is part of the problem when it's low growth. So how can growth be a problem both ways? The answer is the difference between the short-run and the long-run and the difference between anticipated and unanticipated.

So if you have a steady state slow rate of growth, let's say one percent a year and it's fairly stable and steady, that is sort of the optimal situation. The easiest to plan for, the easiest to accommodate, the least costly to finance, et cetera.

When you have rapid growth, you have a problem in the sense you have to go out into the capital markets constantly and raise a lot of money. It's hard to do it with purely internally generated funds from retained earnings and from your depreciation of your older plant.

Once you get above a certain rate of growth, maybe 2 percent or whatever, internal funds just aren't adequate and you're having to go out into the capital markets and you're having to borrow money and you're having to build a lot of plant, and the plant you're building tends to be more costly than the plants that you already have. So rapid growth can cause pressures on the company's financial metrics and lead to rate cases.

Now, the reason the converse is also true is if you have been building for rapid growth and it doesn't materialize in a particular short term, two, three, four, five years, during that period you potentially have a new problem arise, which is you have already got these construction projects underway. There are in the midst of being built and need to be finished. They are planned and you can't decide whether to postpone them or not, because you don't know whether the slowdown is permanent. And they were anticipated to be needed a year from now or two years from now or three years from now, and so your tendency is to keep building.

Even if you slow down your rate of construction, it may not slow down as fast as the slowdown in your revenue growth. So what you get is a mismatch in which revenues have slowed down, revenue growth has slowed down drastically from, say, 5 percent a year to one percent a year, while your construction growth may have slowed down from 5 percent to 3 percent because of certain momentum, a fly-wheel effect of construction programs, as well as the obligation to stand ready to serve.

Many construction programs are designed to be completed two, three years from now, and they have a 20, 30, 40, 50 year life. So it isn't necessarily prudent just to slam on the brakes and stop every construction project you've got and sit tight. And so if you can't do that, if your customers have turned off the light switches and are no longer growing in their usage, your revenue suddenly goes to, say, one or zero percent growth, but your capital program doesn't immediately go to zero, and it would not in a prudently managed company.

So during that transitional uncertain period like the one we're in right now, you have a whole different problem that comes into effect in which you potentially don't have the revenue growth that you have historically had, and yet you still have some of the lingering effects of the previous growth and the required investments and capital expenditures that carry on from the earlier growth.

This whole thing was one of the major issues from RUCO's point of view during the negotiations is trying to set up -- there's no way for this Commission, or certainly not for RUCO to second guess this process. We know what's going on. We know the concern.

It's management's responsibility to manage it as prudently and effectively as they can, and we want to make sure they have the tools to deal with this in terms of a reasonable level of funding, but we also want to have some very strong signals of cut back your construction if you can. And if you have got certain projects that you can sit there and say, well, it's not a safety concern, I can ramp it back up quickly, let me go ahead and slow it down and shut it down, that's one of the places that you can get some of your expense savings because you don't have the operating costs of operating that new subdivision, or new substation, excuse me, or whatever it might be.

So by setting it up the way we did in this agreement, we are hopefully giving them every incentive we can to look very closely at their construction projects and try to make some very tough calls on how much to cut back. Because none of us in this room today know whether growth in Phoenix is going to be sitting at half a percent for the next six years, or whether it's going to return to the kind of growth we've seen for the last couple of decades.

I'm not a student of the Great Depression to the extent of Ben Bernanke, but all economists go through a certain amount of training. I don't think you could train on the whole history of the Great Depression.

And you're sitting there in 1930, 1932, Roosevelt thought he really had it beat and he was solving all of the problems. Things moved up a little bit, and they went right back down again because they made some mistakes and some decisions they made were bad. Some of the decisions the Federal Reserve made were bad and it ended up with a depression that lasted for 15, 20 years. Whatever that number is, from '29 to '40, '39, ten years. Basically, it really didn't pull out until World War II, despite all of those efforts of the New Deal.

So my point being, not that we're in a great depression, just that we're in a time period where there's a lot of uncertainty, and it's far more than anything this Commission can deal with. There's uncertainty at the federal level of how the Treasury and the fed are dealing with their issues.

There's uncertainty about people's attitudes about a state like Arizona. To some degree it may be that the idea of a dream home in the sun in Arizona is going to become damaged goods when people realize, well, gosh, some people had their life savings wiped out because they bought a $500,000 home, and a year later it was suddenly worth $300,000, and it just leaves a bad taste in my mouth. I don't want to go there. I'm going to stay right here in Cincinnati and deal with the winter.

We don't know whether that's going to happen. I'm not saying that it is. I'm just trying to explain that we're in a period of uncertainty, and this company is right in the middle of that perfect storm of trying to deal with that uncertainty about the growth.

Q. Okay. Thank you. Let me go through a few questions from Commissioner Pierce now.

With respect to rate of return regulation for utilities, would you agree that the majority of the states in the nation premise their weighted average cost of capital analysis on the utilities' original cost rate base?

A. Yes.

Q. Are you aware of any state other than Arizona that does not premise their weighted average cost analysis on the original cost rate base?

A. I think Arizona may be the only one that puts as much emphasis on the fair value rate base as it does. There are at most a handful of other states that at least nominally take a glance at fair value, but at most there's a few, and none of them put as much weight on it as Arizona does.

And in Arizona, the original cost portion of the process is still very important. Even though it's a fair value state and quite properly fair return on fair value continues to be considered, it is a key factor in the final decision. In order to maintain direct comparability to the data that's available from Wall Street, the industry generally, for any number of reasons, it's absolutely imperative to continue to give significant weight to the original cost data.

Q. Commissioner Pierce says that, in other words, most other public utility commissions in the nation would assign a rate of return on APS's original cost rate base, which is $5.5 billion, instead of APS's fair value rate base, which is $7.6 billion.

And would you agree that this difference creates an optical illusion with respect to the return on equity authorized it by this Commission relative to the return on equity authorized by other states?

A. No. I think at least not an optical illusion. That would confuse Wall Street analysts and informed investors. They basically look at the earned return on book equity, and that is, you know, where the rubber meets the road. You can put all of the numbers you want in the Commission order. You can say we're granting them a 4 percent return on equity, and that's, you know, down in the range of CD rates, and then turn around and give them enough money to earn 12. Folks on Wall Street are going to pay attention to the 12 that they actually earned and not the fact that the order said 4. Or vice versa, you can say, as it does in this order, that, you know, we've calculated this based on 11 percent.

But the reality is the dollars are what they are, and they are not particularly heavily influenced by the 11. I don't think there was more than 20 minutes of discussion of the 11 percent. The tough issue was how much money did the company need to sign on to an agreement, and how much were folks like RUCO willing to agree to. And that decision was made heavily based upon the financial metrics, the projections, our own opinions as to what was going on, the risks, all of those factors.

The 11 percent, frankly, was acceptable at least to RUCO's point of view because it was in the range of our estimated cost of equity. Frankly, it was higher than our best estimate, but it was in the range. It was not a non-credible number. It was something that we in good faith could accept in these extraordinary circumstances.

But frankly, if it had been a 10 percent or a 12 percent, I don't think the bottom line in the case would have been much different, because it was the nature of that dilemma that people were looking at. If we gave them a little lower return on equity, there would have been a little more money somewhere else in the decision, I believe.

Q. Okay. In this case, if the parties were to agree and the Commission were to adopt the company's original cost rate base as its fair value rate base, the Commission would have to increase the ROE authorized in this case from 11 percent to 12.02 percent to maintain the $344.7 million revenue increase proposed by the parties; isn't that true?

A. I have heard -- or I actually heard over the internet Mr. Smith's testimony where he was quibbling between 12.02 and 12.06, and basically saying that it sounds about right. Although it wasn't quite a match, the arithmetic, I didn't bother getting my own calculator out to try to decide which of those two numbers I would calculate.

I agree with the principle that there is an extra little boost to the chance of what they're going to actually earn through the fair value process. And I think that's proper and fully consistent with the constitution and consistent with this Commission's obligations to follow the constitution.

But again, I don't think they're going to earn even 12.02 in reality. But were they to do so, I still think that would be acceptable because it's within the range RUCO's own rate of return witness presented. It's right up there. I mean, he said way up high from -- basically from 6 percent to 12-and-a-quarter, depending on which metrics you looked at at this time where the numbers where all over the place. But there was at least some plausible data suggesting a cost of equity for this company could conceivably be as high as 12-and-a-quarter. So if they earned 12.06, that's not outside the range of reasonableness. It's not unfair to customers.

Conversely, if they actually end up only earning around 9 or 9.6, which some of the people in the room believe is a more realistic estimate of what might come out of this process with all of these uncertainties in the next year or two, that's also fair and reasonable, and it happens to be very close to RUCO's best estimate in their evidence they presented as to the best estimate for the cost of equity.

But again, from Wall Street's point of view, the actual earned returns are what is really going to matter. They don't necessarily focus too much on any one quarter or even any one year. But if year after year you're earning 7.5 or 8 percent, that's noticed. And hopefully we'll have some good years in here where we get closer to 10 to help average things out, but we haven't had it lately.

Q. Okay. Commissioner Pierce asks if he were to offer an amendment that adjusted the $7.6 billion listed in paragraph 3.5 of the settlement agreement to $5.5 billion, but increased the 11 percent listed in paragraph 4.2 to 12.02 percent, would RUCO view that as a material change? And if so, why?

A. Well, I'm not sure I can speak for RUCO on that. That's certainly something that the director would ultimately make the decision on. If she were asking me my opinion, technically I don't think it's material at all in the sense that the bottom line, if I'm understanding correctly, would be the same. The rate increase amounts would be the same.

The only concern would be doing it that way might run afoul with the court's interpretation of the constitution. This whole issue is a little bit unclear right now, and there's been at least one or two court decisions but not final resolution. It doesn't seem like an especially auspicious time to push the envelope on whether you can give almost no consideration to the fair value number in the final decision, even if the end result would be the same.

Now, if you made it clear in the order that you kind of did it circuitously, you looked very heavily at the fair value and figured out that 12 number and did all of that, which is what I'm hearing, but now to try to state things in terms more comparable to other states we're going to present the result in a certain way in a table or a presentation for comparability, I don't think that would be a material change. I don't think that would be a problem from my perspective personally. It's all a matter of how it's worded.

Again, if the company, for example, or any of the parties that are nervous about an appeal started becoming concerned that what the Commissioner is asking is can we basically throw the constitution out the window and not worry about how the courts would react, I think there's a lot of folks around that would say, no, no, no, we don't want to do that.

That even though there may not be any parties who can appeal this particular decision, it creates a precedent that would be problematic for other companies in other cases and create a track record that the courts may say, you're not paying attention to us. We're telling you fair value is the constitution and you have got to use that as a central element in your analysis. I think the courts have been pretty clear about that. It's not necessarily that they care, it's just that that's what the constitution says, and it's their job to protect the constitution.

So I think we've got to be careful about keeping our priorities right, and in this case I think the constitution trumps Wall Street.

Q. Okay. Let's move on to some questions, and these are specifically coming from Commissioner Pierce related to the settlement agreement, certain paragraphs.

Do you have a copy of the settlement agreement?

A. Yes.

Q. I think the first question is very similar to the one I asked you on behalf of Commissioner Newman, and it goes to the value of the two year stay-out provision.

And basically the question is: What is the value added by the two-year stay-out provision? In other words, what would APS have done otherwise?

A. Well, I can't speak for APS. I would say, if I were them, I would have filed a rate case in February or March of 2010 but for the stay-out period. That would be fully consistent with their presentation they've been making to the Commission that they want more money and they want it as soon as you can give it to them, and they need it. So it would be fully consistent on their part to have come in almost immediately no matter how generous the settlement.

Even if the rest of the dollar numbers in the case were the same, but for the stay-out I think they would have had strong incentive to come in immediately. And knowing how long it can take to process a case, you know, they might have been saying, well, if it takes another year and a half or two years, you know, the sooner we get it in the better.

So at least one of the values of the stay-out is it creates more certainty for customers and it allows us to analyze the 7.9 percent non-fuel increase or the one percent net increase, however you want to look at it. It allows us to analyze it with some degree of certainty as to how long a time period do I compare this for? Because I'm trying to get some common sense notion of is this an excessive rate increase or is it reasonable? Is it fair to ask customers?

When you're looking at, in essence, 4 percent a year over two years or, you know, a little bit less than 3 percent over 3 years, which is one way you could look at it since the last case to the next one, that's different than saying, well, this could be as little as a year, year and a half, so potentially 3.5 percent a year. So that certainly helps and makes it easier for the Commission to judge the measure.

And to the extent, in fact, it ultimately defers the next rate increase, then it also provides some relief to customers, and I think it does. I think most likely it would defer the next increase. What makes it a little hard to say is, because the Commission is involved, how quickly would they process another case? If it had been filed in early 2010, how quickly would they have processed it? Conceivably, the Commission could have been so offended by it that they would slow-walk it and take three years to process it, and the end result might have been the same.

I'm realistic enough to see that and that if the Commissioners are sitting there and saying, I don't care what they file, there's no way we're going to give them another rate increase right away, maybe in their minds there's not much value here. But from RUCO's point of view, not being able to see their minds, and with some of the Commissioners new and not having a track record on how they were going to perceive some of these issues, there was some value there of having some certainty in knowing that we had a stay-out for at least two years.

And, you know, it would have been nice to have three or four years without another general rate case. RUCO offered some things during the process in an effort to get there, but it didn't happen ultimately.

Q. Do you know why the settling parties -- and this is going to paragraph 3.11 -- why the settling parties changed their minds with respect to the issue of the collection of the DSM costs in base rates instead of the adjustor?

A. I think I can talk a little bit about that without stepping on toes or disclosing anything confidential.

The parties were looking at it, and it was something that because it was up for grabs at the time, they were under pressure to file the public terms sheet and there was some concern because there was a lot of serious discussions. Some people in the room were seriously looking at it and wanting to put all of the DSM costs into a single line item for public disclosure purposes. That there was a feeling that we better say something about this in the term sheet rather than potentially skew the subsequent discussions amongst the parties.

But as it turns out, in the subsequent

discussions the consensus was to not rock the boat and try to -- sort of a bridge too far. We had a lot of things going in the agreement. There was some concern -- I don't know that there were any parties who were adamantly opposed to it, but there was some parties that -- or participants that had concerns that it might have some unintended consequences. And therefore, the sense was let's not try to do it right now. We've got all of these other things happening. This is something we can always come back to in a year or two or in a generic proceeding. There's any number of opportunities to look at it again.

Q. If an amendment required all DSM costs to flow through the adjustor, would RUCO see that as a material change?

A. Again, ultimately, that would be the director's call. If she were to ask me, I would advise her to say no. From RUCO's point of view, that's a relatively minor issue. It would not be material. In fact, RUCO sees some significant benefits to putting it in as a line item in the bill where you can see the entire cost and not a portion of it, which makes it sort of a mysterious like an iceberg. You don't know what is there hidden.

So there's clearly some benefits to having it disclosed, just as there would be some benefits to disclosing other types of items in a clear manner. The trade-off, of course, for some of the items that aren't being disclosed is the bill starts getting pretty complicated. You have too many line items. But in this particular case, we have already got a line item. Why not make it meaningful to consumers where they can see it?

Other participants have some concerns that it's not quite as simple as that. It's not just the public disclosure concerns that RUCO tends to focus on. It's other aspects of it that need to be carefully thought through, and I respect their concerns.

Q. How will the proposal to treat Schedule 3 proceeds as revenue affect APS's capital structure?

A. I'm not sure. Offhand, I can't think of any obvious impact. Offhand, I can't think of any obvious impact. I'm not sure it matters. I would have to really study it and run some scenarios and try to figure out whether it can make an impact, or maybe somebody else has thought it through and they can show me.

But offhand, I can't think of a reason it would have an impact on their financing needs or capital structure. It primarily has an impact on their earnings per share that are reported to Wall Street, which is positive for the company and it reduces rate -- increases rate base -- excuse me -- by failing to reduce rate base by the CIAC amount, which is a negative to customers and something that RUCO fully understood when they agreed to it.

Q. Will a customer financed line extension booked as revenue have the same impact on APS's capital structure as a line extension financed entirely by equity?

A. Neither one directly affects capital structure and neither one is going to be 100 percent equity financed. It's the nature of the process. To the extent they build something and get reimbursed for it, to the extent you want to ever trace money from one hand into the other, say, well, how did you get the money to pay for that, a customer provided funds is about as close to a tracing as you can get. The customer handed you the money, you were able to use it to make the investment without having to find some other source of funds. You don't have to go to equity, you don't have to go to debt. You use the customer's check to basically pay that part of your employees and your suppliers and other expenses of putting in the line extension.

Q. Is customer financed infrastructure booked as revenue essentially an equity infusion?

A. No. What I would describe it as is a short-term, temporary boost to earnings per share, which is something that some folks on Wall Street pay a lot of attention to, others maybe not quite as much, but it's pretty important to investors and to investor analysts as a way of boosting that.

This particular treatment, really, I don't believe has an impact on FFO-to-debt, because you would have a cash flow either way. It's just -- maybe there are some subtle impacts on that that I haven't thought through, but I don't believe so.

I think what you're really talking about is it increases earnings without requiring any customer group to pay more in the short-term, but it will eliminate what would otherwise have been a deduction from rate base in future rate base cases, future cases, that would normally have been there for that particular year's CIAC that would normally have been booked.

CALJ FARMER: I think we can take a break here and come back at 3:30, but I do want Staff to know that Commissioner Mayes has some questions, just a few for Mr. Abinah, so if he can be on standby. Maybe when we finish Dr. Johnson he can come back. I think it literally is three questions and shouldn't take too long.

Okay. Other scheduling issues anybody want to talk about now before -- at least while we're still on the record?

MR. MUMAW: Yes, Your Honor. It had been our intent to call Mr. Rumolo today for at least a portion of his testimony. It's my understanding that certain parties, specifically those represented by Mr. Crockett, feel that it's very critical to them to be able to examine Mr. Rumolo. And as I think Mr. Crockett previously indicated, he would not be here later in the week. So I thought if we could get Mr. Rumolo on, and even if he did nothing else but respond to Mr. Crockett's questions, that would at least accommodate his schedule on that. So that was one thing.

And then the other thing, as I think I spoke briefly to you, I have been looking and exploring ways to salvage Wednesday, which I know Your Honor previously had indicated was an available date, but which we had kind of scratched because of Mr. Crockett's unavailability. I had spoken to him and we had discussed the possibility if we could present one or more witnesses on Wednesday which Mr. Crockett's clients essentially have no need to cross-examine, whether he would be amenable to it, and I believe he indicated that he would be.

And I have briefly spoken to some other parties about the potential of placing one or more witnesses on the stand on Wednesday. And, you know, specifically I was thinking of Mr. Yaquinto and Cynthia Zwick. And, obviously, if possible, Mr. Hatfield were the witnesses that I specifically discussed with Mr. Crockett and with some of the other parties.

MS. WAGNER: Your Honor, since Mr. Mumaw spoke to me earlier, it's come to my attention that there may be a Staff open meeting on Wednesday at 2:00. I don't know to what degree that factors into your determination.

MR. MUMAW: And I understand, but even if we could only do a half a day on Wednesday, I think it would be worthwhile given I know the Commission's scheduling constraints after the end of this week and the increasing uncertainty as to whether we can otherwise complete the scheduled witnesses by the end of the week.

MR. ROBERTSON: Your Honor, I might as well add to this discussion. Mr. Mumaw approached me earlier today with this proposal that we go on Wednesday. And my situation is driven by the fact that I do have some questions for Mr. Hatfield, who has become an ever moving target, so to speak.

I have to be in Marana for a meeting at 2:30 Thursday afternoon. I had planned to participate in the hearing Thursday morning, and then drive down to Marana to be there for that meeting at 2:30 that afternoon, which will take the remainder of the afternoon.

I don't have a problem going for a portion or all of Wednesday, as long as I have an opportunity either to cross-examine Mr. Hatfield Thursday morning or sometime on

Friday. I'm getting to the point that if this spills over and beyond this week, I'm probably not going to be able to participate in the remainder of the hearings, and I don't want to lose the opportunity to be able to ask him some questions. So I just throw that out in the mix.

CALJ FARMER: So you're not available Thursday afternoon?

MR. ROBERTSON: That's correct.

CALJ FARMER: All right. And Mr. Grant, you wanted to put your five or ten or two, whatever, cents in?

MR. GRANT: Maybe two cents. Well, to slightly complicate things, I have a problem on Wednesday morning because I'm involved in a procedural conference with Judge Rodda on the Universal Service Fund matter at 10:00. I'm not going to go to Tucson, but I'm not available on Tuesday morning. We could -- or I'm sorry. Wednesday morning. The procedural conference is at 10:00 a.m.

If it works, Mr. Yaquinto could be available at 1:00 in the afternoon or any other time during the afternoon. I just have that scheduling problem with another procedural conference on Wednesday morning.

CALJ FARMER: Okay.

MR. POZEFSKY: Your Honor, so I can get my three cents in, we have no problem with Mr. Rumolo going before Ms. Jerich. Ms. Jerich, as I you told, is available --

well, she's in-house, so she's usually available. In fact, we prefer Mr. Rumolo to go first.

And as far as Wednesday goes, I would ask that if we do do something, just a half a day. I mean, like you, this isn't my only case, and I've got hearings starting again next Monday in a bunch of other things. So this is critical, this timing, for me. Thank you.

CALJ FARMER: Ms. Pecora.

MS. WYLLIE-PECORA: I don't know if it makes any difference, but I won't be here Wednesday.

CALJ FARMER: Well, I still have more questions from Commissioner Newman for this witness, and I have a few questions of my own, and we need to bring Mr. Abinah back. I don't think we're going to finish Mr. Rumolo today. But if no one has any objections to putting him on and at least allowing Mr. Crockett to cross-examine him, does anybody have a problem with that today?

MR. POZEFSKY: No.

CALJ FARMER: We could at least maybe get him started.

MR. MUMAW: Your Honor, yeah. I certainly never anticipated in my wildest optimism that Mr. Rumolo would be completed today. In fact, I have some extensive direct of Mr. Rumolo, which I would like to, with your permission, to defer just so that I know that Mr. Crockett will have an opportunity to ask his questions of Mr. Rumolo. And then I can address Mr. Rumolo's response to both some of the initial questions from the Chairman in her letter of August 5, and the not insignificant number of things that have been delegated to Mr. Rumolo by prior witnesses. But again, with your permission, I will defer that additional direct in the interest of allow Mr. Crockett a full opportunity to ask Mr. Rumolo his cross-examination questions.

CALJ FARMER: Mr. Grant, do you have questions for Mr. Rumolo?

MR. GRANT: I do not.

CALJ FARMER: I was just wondering if it would be possible if we could put him on Wednesday morning. You said you wouldn't be here. Would that be okay with you?

MR. GRANT: Yes. I did not mean for the hearing to stop. I just wanted to indicate that I cannot be here and I couldn't sponsor a witness.

CALJ FARMER: Okay. We still have Staff witness Barbara Keene to put on the stand, too, so okay. Let me think about it, but it looks potentially like maybe we could go Wednesday morning.

Is there -- how much cross is there for the AIC witness Mr. Yaquinto?

MR. HAINS: None.

CALJ FARMER: Does anybody have much?

MR. ROBERTSON: I may have one or two questions.

CALJ FARMER: Okay.

MR. ROBERTSON: And I say may. I may have none.

CALJ FARMER: And Ms. Zwick, does she already think she's coming Thursday?

MS. WAGNER: Yes, she does.

CALJ FARMER: So it might be reasonable just to keep Mr. Yaquinto and Ms. Zwick on Thursday morning and try to get through as much of Mr. Rumolo as we can on Wednesday morning, and then come back on Thursday with --

MR. MUMAW: Your Honor, just to interject, it's my understanding that with Mr. Crockett's scheduling constraints, I kind of need to get Mr. Rumolo on today at least for purposes of his examination.

CALJ FARMER: Right.

MR. MUMAW: And then also to alert that Mr. Rumolo will be gone after Thursday.

CALJ FARMER: I didn't know that part.

MR. MUMAW: We need to kind of make sure that we work as hard on him to get him done by Thursday as we can, and with all due respect suggest that if we have to stay on Thursday, we should stay.

CALJ FARMER: Okay. So then I guess the question really is between whether we should put Mr. Yaquinto and

Ms. Zwick on Wednesday or Thursday.

MR. MUMAW: I mean, for our part, I don't think Ms. Zwick is going to take very long, but I just don't know how many, if any, questions the Commissioners or Your Honor may have for her. The same thing with Mr. Yaquinto. I would like to think that both of those witnesses will go quickly, but I've been wrong before.

MR. ROBERTSON: Your Honor, might I inquire through you of Mr. Mumaw when he anticipates at this point Mr. Hatfield might be taking the stand with all of these moving parts in play?

MR. MUMAW: Well, what I'm hearing is that he probably is back on his familiar Friday morning.

CALJ FARMER: I think it depends upon how long Mr. Rumolo takes. I think that's going to be the key for much of this. So Mr. Mumaw, I can't get your preference. Are you saying that you want to put -- to move back Yaquinto and Zwick to Friday, or are you saying --

MR. MUMAW: No. I would like to take them as soon as possible. That's all. I just heard -- maybe I misinterpreted Mr. Grant saying he wasn't available Wednesday morning, and people saying that Ms. Zwick had already planned on being here Thursday.

CALJ FARMER: I thought I was hearing from you that you didn't -- that you did not want them to be on

Thursday because you were concerned about Mr. Rumolo finishing.

MR. MUMAW: I am. But as much as I would like to unilaterally move up Mr. Yaquinto and Ms. Zwick, I understand that I don't really control them. So we can contact Ms. Zwick and see if she could be available on Wednesday. I just don't think she had been asked that question because.

CALJ FARMER: Let's just keep her on Thursday morning.

MS. WAGNER: We have contacted her with Thursday in mind, and she had responded saying that she would be available anytime on Thursday. We did not ask her about Wednesday.

CALJ FARMER: Okay. Let's just go ahead and schedule her for Thursday, and let's go ahead and we'll start again at 9:00 if we're concerned about getting Mr. Rumolo off. And let's put Mr. Yaquinto on right after Ms. Zwick on Thursday. And then --

MS. WAGNER: Who is on Wednesday?

CALJ FARMER: These are both Thursday.

MR. MUMAW: My understanding would be Mr. Rumolo.

MS. WAGNER: But who is on Wednesday?

CALJ FARMER: This afternoon and Wednesday is Rumolo.

MR. MUMAW: This afternoon and then Wednesday morning for David Rumolo. And then maybe I'm pessimistic on this, I think he will still be on, and then come back to the stand after we take care of --

CALJ FARMER: Absolutely. I think that might be the case. I don't know. But if we're not finished with him on Wednesday, then we will pick him up again Thursday after Mr. Yaquinto and -- Ms. Zwick first, and then Mr. Yaquinto.

MR. MUMAW: Yes, that's my understanding.

CALJ FARMER: Now, Mr. Crockett, is this going to -- this doesn't pose a problem for you, does it?

MR. CROCKETT: Your Honor, if I can be accommodated so that I can ask the questions of Mr. Rumolo today, that will take care of the matter for me. Patrick Black will sit here in my place for Wednesday and Thursday. But as you well know, he has not been participating in this proceeding and so would not be in a position to ask the cross-examination questions that I would like to ask of Mr. Rumolo.

CALJ FARMER: Okay.

MR. MUMAW: And, Your Honor, I would be remiss at this time if I didn't on the record thank Mr. Crockett, and for that matter the other parties, for being willing to consider some reshuffling so that we could get at least a partial hearing in on Wednesday, and that was greatly appreciated.

CALJ FARMER: I think we still have a problem with Mr. Robertson maybe for Thursday afternoon, but you'll be back on Friday if Mr. Hatfield is on on Friday?

MR. ROBERTSON: Yes. As long as Mr. Hatfield is not on on Thursday afternoon, I have no problem.

CALJ FARMER: Okay. Well, we've talked through our whole break, so we better schedule another one. Let's come back at quarter till. Thank you.

MR. ROBERTSON: Your Honor, may I make a light-hearted observation?

CALJ FARMER: Sure.

MR. ROBERTSON: With all of the rescheduling and extending, we've already added one year to the stay-out.

(A recess was taken from 3:27 p.m. to 3:45 p.m.)

CALJ FARMER: Let's go ahead and go back on the record.

Q. (BY CALJ FARMER) Okay. This is referring to Commissioner Pierce's question on paragraph 6.1 of the settlement agreement. And he says that while he was supportive of the notion of the 90/10 sharing provision and the PSA in the past, he's concerned that the provision has actually the potential to cut against the interests of ratepayers in this case given the probability that has been discussed for APS to overcollect its fuel costs in base rates.

And he's asking, why should he support this aspect of the settlement agreement despite documented declining fuel costs?

A. I believe he should -- the answer is because it is a mechanism that is in the best long-run interests of ratepayers for all of the reasons that I mentioned earlier, and that it's fair -- and it's also important to be fair in all of these mechanisms. And its fairness, in part, derives from the fact that it cuts both ways.

When you do have a period of declining costs, the mechanism works in a symmetrical manner. That's part of the decision the Commission made in setting it up. It made the decision to have a symmetrical arrangement. And having made that decision, I think it's important to maintain the consistency of it. Perhaps they could have set up an asymmetrical one, but it was not set up that way. And as a symmetrical arrangement, I think it's important to maintain continuity.

Q. Okay. Going on to paragraph 6.2, Commissioner Pierce states that it is his understanding that the adoption of the per kWh cost that is set forth therein for the base cost of fuel and purchased power would result in an additional $11.2 million of revenue.

If there is a probability that APS is likely to overcollect its fuel costs in 2010, why shouldn't the Commission adjust this number downwards now?

A. Well, the premise in the question -- and I'm not sure what was meant by an additional $11 million in revenue -- but I don't believe that's a correct assumption, or at least that's not my understanding of the numbers.

As shown on Page 13 in the table, my understanding is this is an increase in base rates that is rolling into base rates something that was already in effect through the PSA. Somewhat analogous to the interim rate, that the interim rate has already been in effect and is on consumer's bills, but it will now become part of the permanent base rate through this decision, if the Commission adopts the agreement. So I don't think that this is truly a major increase in bills, but -- so I'm not sure about the premise. I may be misinterpreting the numbers, but that's --

Q. Well, if you look at -- do you have Page 13 of the settlement agreement? I think he's getting it from the far right-hand column, the second line down where it says fuel related increase in base rates.

A. Yes.

Q. I think that's the $11.2 million that he's --

A. Oh, I see. Okay.

Q. I think he's basically asking --

A. Well, then it's a roll into base rates of a fuel expense. I think that may be, in essence, the 10 percent that has -- under the PSA, 10 percent is absorbed by the company, and now it's time to be no longer absorbed.

So if it's intended as an actual increase in revenues, then that would be the explanation, that that is the end of the period of sharing. The sharing is a temporary period between rate cases, in essence. And when you true up base rates, the sharing ends.

So now that I understand that, let me hear the original question again.

Q. I think there may be two issues going on here, but one of them I think you have identified as some of it. This is now -- previously had been in the PSA.

But the question was: If there is a possibility that APS is likely to overcollect its fuel costs in 2010, why shouldn't the Commission adjust this number downwards now? And I think the number he's talking about is the base rate for the cost of fuel.

A. Okay. Well, I think if you -- assuming that we're talking about that 11 million that's shown on that, if you look closely at the evidence in front of the Commission, and this was not an issue in which I analyzed in any depth at all, you see that in RUCO's column is simply plugged the same figure from APS. We assumed the company number in our presentation, and we probably made a comment about I hadn't really studied it and was planning on perhaps looking at it after Staff filed their testimony. But at that time I had never analyzed it. We really didn't have an independent position on it.

But looking at the various positions, the final number is very similar to but slightly less than the Staff. It's a bit more than AECC. I assume there's something going on technically there where different opinions could be reached and maybe it's as low as 10 million. But for the Commission to go all the way to zero, I don't quite understand what could be going on where there would be that much discretion involved.

My impression from the fact that all of the numbers are so closely clustered together is that at least to the extent the parties were attempting to carry out and interpret historic Commission practice, there's a very narrow range in which those numbers are. Now, for the Commission to change its policies, it probably has more discretion, perhaps, than the parties were assuming, but I don't know enough about it to know whether there that would be any real reason to.

What I can tell you is if you're talking about something like let's get rid of the 90/10, or let's change the way the 90/10 works, or something equivalent to that, it doesn't seem to me this is a very good time or place to be doing that. This 90/10 has been around for a while, and I think it's a good thing on balance. And while there may be some room to improve it, I would be a little bit reluctant to see an ad hoc kind of case by case, let's just, you know, make this up as we go along and keep changing the numbers. It's confusing enough as it is for people like me from the outside, and I imagine it's confusing for Wall Street analysts. It's certainly confusing for consumers.

The assumption here is that the Commission has rules and they are carried out, and certain premises behind those rules like the 90/10 sharing and the fact that it's symmetrical are sort of a given. And I don't know enough about it to comment as to whether the rules ought to be changed. I just don't know that this would be a good time to be changing them.

If there's something about the rule that's troubling the Commissioner, and I gather from the way the question is worded he is seeing something flawed in this that is troubling him, but I don't know that this is the best time to deal with it.

Q. I think the question may be related to the declining cost of natural gas and whether or not the cents per kilowatt charge is appropriate.

A. Well, what I'm hearing is I hear that maybe he's sort of -- it's dawning on him or he's starting to realize that you have this symmetrical mechanism that when the price comes down, there's supposed to be a benefit flowing to the company and they pick up 10 percent of that downward flow.

And that is part of the mechanism and it's supposed to be there. It's something that was in all of the projections I'm sure that the company was using whenever they were running whether or not they could accept the deal. They were hoping that, you know, to some degree during this period instead of the pain of absorbing 10 percent of an increase, they would either have very little of that pain or maybe some benefit. I imagine they modeled that year by year. They might have seen some benefit for 2010 and pain in 2011.

Again, if the thought -- if the Commissioner is saying, well, gosh, why couldn't we have an asymmetrical mechanism where it's only painful for the company and it's never good for the company, you could do that and there may be some merit to it, but there's also some negative consequences that certainly would need to be thought through carefully.

And again, I don't think it would be wise to rush into that just on the theory that, you know, heads I win, tails you lose. That doesn't really work in regulation, and you have got to be very careful that you have got good, solid principles behind what you're doing so that it withstands appeals, so that Wall Street won't punish you and sort of feel like you're being too arbitrary. There's a lot of good reasons why you want to take the long view.

Q. Paragraph 7, the question from Commissioner Pierce is: Is APS committing to reduce operational expenses by $150 million?

A. Over a five-year period, yes. Well, operational, let me slow down. No, I don't think they've narrowed it to operational. I think what they've said is we're going to reduce expenses. If you look at their expenses, the vast majority of them are operational. I'm sure the vast majority of the savings will come out of operational.

But to the extent they have, say, a category of corporate overhead or some other category that they don't think of as being the word operational, I think if they can find ways to squeeze money out of corporate overheads, that is fine with me.

I know an issue arose about the Palo Verde depreciation, and we anticipate that. I don't believe the intent of any of the parties was that any portion of this

$150 million would be an expense decrease that was already planned and in the works for Palo Verde, not only -- just the whole nature of it, everything in the discussion, there's no way that was intended.

And if it really became necessary, I can't imagine any party would see it as a material change to have the order be very explicit about the fact that the Palo Verde depreciation can't be counted, because I don't think any of the parties anticipated that.

Q. Okay. The next question is would the parties object to an amendment specifying that the expense reductions are operational expense reductions as opposed to generic expense reductions?

A. I can't -- again, obviously, I can't speak for the parties on that level. I do know and I do recall some discussion of this difference between operational expenses and expenses generally. I believe the word was chosen because the feeling amongst the participants was that the company should have the flexibility to cut costs at their actual cash-flow type costs wherever they could.

And if they could find a place to cut costs in something that would not necessarily be considered operational -- let me think of an example. Maybe -- I'm really not sure where they're drawing the lines, so it's hard for me to think of examples.

But let's say they have a tax expense and that they by -- with careful consultation with tax attorneys they determine they can arrange their business affairs in a slightly different manner and reduce their federal corporate income tax expense. And that may not be technically operational, but it's within management's discretion and it's a real savings, there's real money that they're benefiting, I think that would be something for them to be able to look at. Now, whether it's qualified and it's not just a mere temporary reduction but a true reduction, that's a different test. There's plenty of tests in here.

But I don't know that there's a need in advance to limit the company's discretion to what would technically be operational expenses. I think key, really, is they have to be real reductions, things that would not have taken place otherwise.

Q. Well, let me just ask you this kind of as a follow-up then. Then are the expenses that you had in mind expenses that would be included in the ratemaking formula?

A. I would expect them to be, yes. I'm having trouble thinking of anything that would not be. There might be -- okay. Let's say lobbying expenses were cut. I'm just saying that's a question no one has ever specifically addressed. Perhaps they would traditionally be disallowed.

The company finally comes around and says, we're really going to stop spending the money now. I think that's fair game. They would legitimately -- that would be a legitimate argument for them to make. Whether the other parties would accept it or the Commission would accept it ultimately in its audit, I don't know. It's too soon to say. But those are the kinds of expenses, certainly, that at least in some jurisdictions would get passed through to ratepayers, so I think that it's an open question, at least.

But what I see, like the Palo Verde example, as being clear-cut is a -- (A) it's not a real cost cutting. It's shifting money around between generations by, you know, if you have the depreciation expense reduction, it helps people now relative to people 10 or 15 years ago, so it's not a real savings. It's a timing issue that is beneficial to ratepayers but is not something that, you know, meets the criteria that we had in mind when we settled this provision.

(B) it's something that they were already planning on doing and working towards. They already had it in place. It's not something new and different that they're doing, and I think -- so it doesn't meet either criteria in my mind.

Q. Okay. That is the end of the Commissioners' questions. I may have a couple for you here.

A. Okay.

Q. Do you have your testimony? It's R-5, your direct testimony from July.

A. Yes.

Q. On Page 25 and 26 you're talking about the S&P matrix.

A. Yes.

Q. And there you say that this was a June 25, 2008, S&P report. That going over into the next page, 26 on Line 3, you state that the 57 percent debt ratio still places APS near the unfavorable end of the range for the aggressive financial risk category.

Do you see that?

A. Yes.

Q. Then do you have settlement agreement? If you could turn to Page 14.

A. Yes.

Q. The cost of capital paragraph 4.1 shows that the capital structure the parties used for ratemaking purposes had 46.21 percent debt.

Can you explain those differences in the percentages of debt and why they're characterized different?

A. Yes. In essence, the 11 percent difference is the mathematical effect of taking into account purchased power contracts and Palo Verde leaseback and other items like that, the purchased power contracts being the majority of it, that the rating agencies say have, from a bondholders' point of view, have the same characteristics as debt. So they impute them as debt. And so the equity stays about the same, but the debt goes up substantially and, as a result, the percentages change.

And we had calculations available to us during the settlement in which we had actual hard numbers for this that people made an estimate in the company because they were trying to simulate S&P as best they could so we could look at it and understand the logic of it. And I became convinced and strongly believe that the difference is the effect of this state's encouragement of competitive procurements for various types of power.

And the end result of that is those projects go out and they finance their project based on a firm commitment from APS to buy the power. And from their point of view, that makes it easier for them to finance their project, and that keeps the cost of that project down that they have this firm commitment from APS.

But from a bond rating agency's point of view, that commitment is analogous to taking on additional debt. And notice this debt is not secured debt. This is just total debt. So the question of whether the purchased power contract is more senior to the bond or behind the bond is really a moot issue.

But in reality, I think you could argue that the practical effect is it's pretty senior and it's right up there with the bond. That you have committed to buy this power, and if you need the power -- they wouldn't commit unless they needed the power. If you need the power, that's a pretty strong commitment that bondholders have to be worried about.

That say, for example, a bankruptcy judge could very legitimately say you've got to keep paying your suppliers. They come in front of the bondholders. Sorry, we're not going to pay the interest. We're going to pay these merchant power folks for that power so that Phoenix doesn't have the lights go out. That may very well be a legitimate decision by a federal bankruptcy judge. So if I'm S&P, I can see why they would want to make that imputation.

So that's the difference is the impact of these off balance sheet financing arrangements.

Q. Why should the Commission not use that 57 percent debt ratio for capital structure for ratemaking purposes?

A. Well, because the capital structure for ratemaking purposes is a calculation of the portion of the plant serving customers that is owned by APS. So it's sort of like a double counting. It wouldn't be legitimate to take financing arranged for a merchant power plant and use it in a calculation of the cost of financing the transmission lines, the distribution lines, the plants that are owned by this company. They're just two separate calculations. Both are legitimate.

It's a little confusing to see the same word "debt" next to totally different percentages, but they are actually consistent. In essence, the rate base is the percentage of debt and equity financing the plant investment that are available for public service that's owned by APS. Whereas, this 57 is a methodology the rating agency used to look at the total obligations of the company, including long-term contracts for power which are not rate based items, but they're part of its service obligation and part of the way they do business.

Let me try one more since you look puzzled after my answer.

Q. I understand what you're saying. I just don't understand --

A. Let me try a quick analogy. It's a little bit far-fetched, but it's like a distinction between looking at your obligations for, say, credit cards versus your mortgage. And you're sitting there saying, well, what is the amount of debt on the house? It's only 80 percent. But your total obligation, depending on your family situation, it might be a lot worse than 80 percent once you consider all of the credit cards and other things that you have. But if you're the mortgage holder and you're trying to calculate how much debt does this person have, that's the total debt number.

Looking at the financing and the plant and the equipment, the house, that's a different number. So the Commission is looking at how much -- what is the financing of the rate base. That's separate from what is the total contractual obligations of the utility. That's this bigger number that S&P is looking at.

Q. Well, I guess the way I'm looking at it is that if the purchased power agreements have supplanted what would have been rate based, why does the Commission not consider that in determining the company's capital structure?

A. Well, you could, but then what you would have to do, you would have to find a way to bring the merchant power plants into the rate base. Otherwise, you kind of have a mismatch. You've got a percentage that's based on total operations, including plant you don't own, and, you know, applying it to a rate base that you do own. So you would have to find a way to impute into the rate base an adjustment, and I don't think the end result would be much different than what you're doing right now.

Q. So this is one of the reasons why it was important to RUCO that the company make an equity infusion?

A. Yes. That if you were -- if you didn't have all of these purchased power contracts, the existing debt to equity balance is quite reasonable and appropriate, just as it's appropriate for rate base purposes.

But it became apparent that because of the purchased power arrangements, the actual amount of total leveraging, sort of including the credit card debt, has become a problem. And part of the solution is the rate increase, and that's what the company was pounding away at day after day.

And part of our counter was, well, shareholders should take some of the pain here, too. They need to infuse some equity. And they were saying, oh, but the stock might be below book value, or whatever they might have said. And the bottom line was, we don't care. We want some more equity.

And so ultimately the language you see is what you see, which is they've committed to not only more equity, they've committed to improving this ratio and that's -- they're going to have to improve this ratio. They've committed to it. It's a significant change. To go from 57 to 52 percent is the equivalent of, you know, at least 700, 800 million dollars worth of equity, and/or some other adjustments that they might have, some other tools they might have besides just putting in equity.

But one way or the other, they're going to get that ratio to be more attractive, which in turn should reduce the risk of a downgrading and may even see an increase in the rating as a result.

Q. Did you calculate what the fair value rate of return was for the test year?

A. Not recently. I do remember in the original case we had some calculations. I believe -- again, I haven't looked at this in quite a while, but I believe if you were to turn to my original prefiled testimony, Schedule BJ-1, let me see what is on there.

We have a current rate of return on fair value rate base of 3.91 percent.

Q. And that was for the test year, correct?

A. I believe so. Again, I haven't looked at this in quite a while, so I'm a little rusty on it and I may misspeak.

Yes. And the reason it's so low is the way this particular number is being calculated relative to the -- sort of the nature of these calculations. You see later there's a tendency and a need for significant increase under that calculation, but there's this offsetting reduction in the PSA rate such that it nets out.

Basically, what is showing is that the return on fair value, but for the complication of the PSA, is right in the ballpark of what was a reasonable rate of return during the historic test year on a jurisdictional fair value basis. And the essence of the case -- and that's one of the messages I originally tried to explain, was the essence of the case were all of these adjustments past the test year. And they ranged in reasonableness all the way from, you know, a couple of weeks after the test year a major plant investment had gone into effect, to ones six months, nine months, a year, a year and a half later.

So this calculation is what they were earning on what is actually invested during the test year and not considering any of the investments past the end of the test year.

And again, if we were -- but this is a 2007 test year. We're now sitting here in mid-2009. So the way to think of a test year is it is a year, so it's a snapshot of the entire year 2007. If you wanted to have a point in time estimate, the midpoint of that year is sort of the essence or the center of that whole activity. So we're now two years later. We're two years past the test year at this point or the center of the test year. In fact, we're a little more than that. We're two years and a month or so.

Q. And the fair value rate of return in the settlement agreement is 6.65 percent; is that correct?

A. That sounds right, but I don't remember the exact number. I would have to go look it up.

Q. Well, I'm looking --

A. Yes, right here. Yes, it is.

Q. I'm looking on Page 14.

A. Thank you.

Q. I think in your initial testimony you found -- you did some kind of -- some study and found that there may be some mild attrition, I think you called it, historically for APS?

A. Yes.

Q. Does the settlement agreement address that from your perspective?

A. It provides very substantial attrition compensation in the form of various provisions in the agreement, but none of them have the word "attrition" next to them, but --

Q. Can you identify which of those provisions you would consider to address that?

A. Yes. First, if you look at Page 13 and look at the column "Staff Proposed" versus "RUCO Proposed." The vast majority of the difference, nearly the entirety of the difference in those two columns is attrition. The Staff accepted post test year adjustments to various expenses and investments.

RUCO excluded them, and we did that in part because we believed that the approach was improper. That this mixing and matching of a historic test year with all of these adjustments was not the best way to go about it. And while we recognize that some mild attrition was taking place, that whole approach makes it very hard to measure how much compensation is appropriate and what is your basis for it.

It becomes sort of a judgment call, do I stop 6 months or 9 months or 12 months? When do I stop? Why not go three-and-a-half years past the test year? How do you decide when to stop? Similarly, how do you decide whether to include this expense and not that expense? And so that whole process was troubling, and that's what I wrote about in my testimony. So we provided a very clean, clear, pure historic test year, and then pointed out that attrition compensation could be provided without having to go down that path.

But the settlement adopts Staff position, essentially, and that is what -- in essence, the dollar amount you're seeing here is the Staff position, plus a little bit extra. If you look at the comparisons, it's about $40 million extra, and that $40 million extra was in large part -- some of it was to close the gap with the company, but some of it was to help finance the extra year stay-out, and that's one simple way of looking at it.

The parties were very aware of the fact that Staff had filed what they did. They had AECC's position, which there was some risk that the Commission would split the difference between AECC and Staff, and yet we would have another rate case right on the heels of this one. So that was one of the issues is we don't know where the Commission is going to come down, but when their Staff says 155 million, the odds of 120 or zero were a lot less than the day they filed 155 million.

And similarly, on AECC saying 200, and they have a respected analyst and a respected point of view, and again, the whole nature of the debate was sort of, well, how far do you go past the test year? Why not go two years past the test year? Where do you draw this line?

So it wasn't like you had a very single, specific issue that you really had confidence the Commission was going to reject this one adjustment. You had a whole series of adjustments. And it was very hard, certainly for me and for RUCO, to judge how, if the Commission were to disagree with some of what the Staff had done, which particular adjustments were they going to disagree with? There's almost no way to know how much less than 155 it might be.

But in return for giving 40 million more than the Staff was recommending, what you got was an extra year stay-out, plus all of the other provisions, including the commitment to boost the capital structure and all of those things. I won't repeat myself. But you had a whole package of additional things that came into effect.

So to the extent that you're looking at weighing what would have been the outcome of a litigated case, let's assume it would be somewhere in the vicinity of Staff, or some way midway between Staff and APS proposed, you would be somewhere in the same vicinity of this dollar amount, but without all of the other things that are in the agreement.

And if you're willing to assume that the Commission would have given them zero and reversed the 65 million and go to zero, I mean, that's a pretty unlikely scenario. But certainly when you look at it that way, then you're saying, well, is there enough in here to cancel out 196 million? I don't know. We never looked at it that way. We were looking at we've already got 65 million that's likely to go into effect. We've got Staff saying 155 million. It's likely the decision is going to be in that range or above.

By participating in the process and trying to get a stay-out, which we ultimately got by trying to get these other things, we gave some ground on some money and we gave up maybe the long shot of getting something substantially less than 155 million, but in return we think we got a very good agreement, including the benchmarks and the performance provisions and a lot of other things that would have been very unlikely to come out of a litigated proceeding. Just the attention of the parties would have been totally on litigating the key issues, and there wouldn't have been a lot of time to talk about those things.

CALJ FARMER: Okay, thank you. Those are all of the questions that I have for the witness. Are there any further questions from the parties?

Mr. Robertson looks like he has a question. Mr. Pozefsky, you want that question asked before you ask follow-up?

MR. POZEFSKY: Please. And I just have a few.

CALJ FARMER: Mr. Robertson.

MR. ROBERTSON: Thank you, Your Honor.

FURTHER CROSS-EXAMINATION

Q. (BY MR. ROBERTSON) Dr. Johnson, in responding to several of Judge Farmer's questions, which I believe she posed on her own behalf, you gave some examples of situations where APS entering into a contract with a merchant plant in order to advance the construction of that plant could result in an imputed debt situation.

Do you recall that testimony?

A. Yes. The thrust was not so much the financing of the plant so much as the nature of the power commitment. That if there was a strong commitment to buy the power, then the S&P is going to put a lot of weight on that in doing these calculations.

If it's more of a short-term arrangement in which they have the option of buying the power and if they don't want the power they can say no, then, obviously, the imputation would be different in a way that its impact on this 57 percent would be much milder.

Q. Let me give you a couple of hypotheticals that are real-term hypotheticals. APS has entered into two purchased power agreements with two large solar plants that are to be constructed here in Arizona, and those PPAs are a part of the company's effort to comply with the Commission's REST regulations. One is known as the Solana plant and the other is the Starwood plant. And I believe in each instance those will have a PPA of 20 years or more in duration.

Would those be situations where the rating agencies would assign an imputed debt to those particular contracts?

A. And I gather APS is committing to buy the power from these solar projects?

Q. That is my understanding, yes, sir.

A. They can't just say -- on 30 days' notice say, no, it's too costly, we don't want it, just sell it to someone else?

Q. Let's assume for my purposes the contracts provide APS is obligating itself to purchase power for the entirety of the contract.

A. Then I would think they would impute as debt a number derived from those payment flows. It may or may not be -- it would be somewhere in the same ballpark probably of what it actually cost to build the plant, but it could be less than that. It's going to be some number. They're going to calculate what is the effect of this for the net present value term? How big an obligation is this?

Q. Okay. Now, that last part of your response may have answered the next hypothetical I want to present to

you, again based on real facts.
The Mesquite power plant, which is one of my clients, it's a 1,250 megawatt plant, was built in the early 2000s. It was built without any long-term PPAs with Arizona utilities. It periodically participates in RFPs here in the state of Arizona.
Let's assume for purposes of my question APS enters into, let's say, a 5- or a 10-year PPA through which it contracts to purchase all or a portion of the output of the Mesquite plant. How would you go about imputing the debt associated with that? And more as a threshold question, is that a situation where a rating agency would actually impute any debt?
A. I would expect they probably would impute some, but it would be significantly less than the actual carrying costs or investment in plant. That they would be doing some kind of a net present value of the obligation. It it's only a five-year obligation and it's a 20- or 30-year plant, it's going be some fraction of that 20 or 30 years' worth of total value that APS is obliging itself to.
They actually have some language in their disclosure documents that they present to the investment community and their clients explaining the process in general terms. And I've read those and it's been a little

while, but my impression is that they don't tell you exactly what they're doing, but the intent is to figure out how much is -- they're trying to put an apples to apples comparison of this obligation. If it's a 30-day obligation, they probably don't even run the calculation. If it's a year or two, they are going to run a little bit. Five years is significant enough I'm sure they would be doing a calculation and it would be contributing to the 57 percent, but a lot less than if it was a 20-year obligation.

Q. Would it be accurate to say that the manner of determining the debt to be imputed and the calculation of it will be substantially influenced by the specifics of the contract in question?

A. Yes.

MR. ROBERTSON: That's all I have. Thank you, Dr. Johnson.

CALJ FARMER: Anyone else.

MR. MUMAW: Just a handful, Your Honor.

FURTHER CROSS-EXAMINATION

Q. (BY MR. MUMAW) Dr. Johnson, I think you indicated that you didn't anticipate or didn't believe that the decision or determination as to the accounting treatment of Schedule 3 proceeds would affect FFO; is that correct?

A. I was saying I couldn't visualize right offhand how it would have an impact and, if so, what would be the direction. I certainly wasn't testifying that there's a guarantee there is no impact. I just haven't thought it through, and it doesn't immediately strike me as obvious as to what that impact would be, if there is one.

Q. Dr. Johnson, is it true that the S&P does not consider CIAC to be a fund from operation?

A. I don't think it would. It certainly -- I wouldn't consider it a fund from operations, so I wouldn't think they would.

Q. On the other hand, if Schedule 3 were considered revenue, would it not be a fund from operation?

A. It might be, yes. To that extent, then you might have additional dollars in the numerator that otherwise wouldn't be there.

Q. And that would be -- at least that would tend to increase the fraction?

A. I can see the logic of how that might work, yes. Now, the question, though, would be: Is revenue from a line extension a fund from operation? I think that may be something that hasn't really been thought through carefully.

Revenues typically are from operations, but when they really get into it and start parsing things, sometimes they start noticing and saying, well, that's really not operations. That's more analogous to when you sell your cars or vehicles and they might make an adjustment.

So it's not guaranteed, in my mind, unless I see a document or they say, yes, we're going to include it in FFO. I don't think it's guaranteed, but there is a good chance that they would let it roll, either intentionally or not even noticing, it would end up in the numerator.

Q. You also indicated that you believed that the classification of Schedule 3 revenues would improve the company's earnings; is that correct?

A. Yes. That one was pretty clear on me.

Q. And if it improved the company's earnings, all else equal, wouldn't that raise the equity ratio?

A. Yes. If they had some extra retained earnings, that would help.

Q. You testified in response to a question from Judge Farmer about the fair value rate of return that you had found in the original testimony. Do you recall that?

A. Yes.

Q. Do you recall that in calculating that fair value rate of return, did you attribute any return of what we call the fair value increment?

A. Generally, that would be at a separate step in the process in which you're computing the allowed return on fair value, et cetera. And no, I don't recall. I don't believe I did that process, and, therefore, I did not focus on any such item.

Q. Okay. Lastly, Dr. Johnson, you described APS as suffering from mild attrition. I think that was the phrase.

A. Yes.

Q. Obviously, mild is in the eye of the beholder. But are you aware of another utility that you can cite to us today that has had historically more severe attrition than Arizona Public Service?

A. Well, I haven't done an analysis of APS relative to other utilities, so the answer is no. But I believe that over the historic time period that I was looking at, the attrition is there but mild. It's sufficient that some compensation one way or another, either through post test year adjustments or otherwise, certainly would be reasonable.

The real question and the real concern here is that mild attrition problem could have become a more significant or severe one during 2008 and 2009 after the test year and after the historic time period given what happened in the economy and what has happened with the slowdown in growth and the things I talked about earlier.

So in my mind, there's no inconsistency between saying historically it's been a mild attrition problem, and saying that there is a good chance that that attrition has become more severe, and so greater compensation would not be unreasonable in this case.

MR. MUMAW: Thank you, Dr. Johnson.

CALJ FARMER: Okay. RUCO.

MR. POZEFSKY: Thank you.

REDIRECT EXAMINATION

Q. (BY MR. POZEFSKY) Dr. Johnson, I just wanted to follow up on some questions that the Commissioners asked you.

With regard to the FFO-to-debt ratio that Commissioner Newman was talking about, can you expand a little on why 18 percent and above is desirable?

A. Yes. In general, higher numbers are desirable because they provide a greater cushion for bondholders. The whole purpose of the rating process is to evaluate the risk. And for a bondholder, there's not a lot of upside in the sense of, you know, a windfall if the company does really well or whatever. But on the other hand, they're very much concerned about the downside risks of default and not receiving their principal back. So that's why you have rating agencies and that's where the whole focus is, is trying to figure out, hey, we're lending you the money.

The whole issue is that ultimately this may turn out to be a GM that for the longest time was extremely highly rated and was rock solid and a blue-chip company, and ultimately those bondholders lost a lot of money. So the rating agencies are tasked and paid to help evaluate those risks. And in that context, this ratio is very useful because it provides a measurement of how much cushion there is in the operations to help cover the interest payments, and to do it in a way other than the FFO-to-interest ratio. So you have got that ratio which is -- this company actually looks pretty good. It's a 4, which is well up there on that matrix we were looking at earlier.

But the FFO-to-debt is an alternative view of the same company, and it's useful for dealing with things like imputed debt from long-term, off balance sheet financing, for example. It helps with that. And it helps provide a sense of -- well, let's say, for example, you happen to have low interest rates. You have a lot of pollution control bonds at very favorable interest rates or other things, while the FFO-to-interest can be distorted when comparing different utilities. Whereas, the actual principal amount of those obligations may be substantial.

So it's an alternative measure of how robust is the cash flow from customers to help provide assurance. And when we're talking about a number like 18 percent of debt, well, if you visualize if your typical interest and principal payments are going to be something like 8 or 9 or 10 percent of your debt, then you have got a margin there. At 18 you're almost double the amount of the typical day-to-day needs of paying the bonds. At 20 percent you are at roughly double.

That's principally you get this idea of why any number below 15 is starting to be sort of problematic, and a number up there in, say, 40 to 60 percent is extremely strong, because the actual day-to-day interest payments and principal retirements are typically going to be, you know, a whole lot less than 40 percent of your debt. I mean, most companies don't pay 40 percent interest rates, and they certainly don't retire 40 percent of the debt every year.

So if you had a 40 percent FFO, that's a very strong company with relatively little risk to bondholders. That's why it would be classified in the top row of this matrix and tend to lead to a AA rating for the like.

Q. Dr. Johnson, one of the goals for RUCO in this settlement was to provide a roadmap to get the company to the point where it was at 18 percent or higher; is that true?

A. Yes. We're actually hoping to get it up towards 20, 25 percent, which I think is doable.

Q. And there are other financial metrics that rating agencies also consider; is that true?

A. Yes.

Q. And one of the goals, of course, or one of the things that we were trying to do with regard to those other financial metrics, as was the case with the FFO-to-debt ratio, would be to improve those financial metrics, too; is that correct?

A. Yes. All of the provisions in the agreement, including the rate increase and the additional cash to be paid by customers, will tend to move all of these metrics in a favorable direction.

Q. And if, in fact, they are brought into a favorable position, is there a likelihood that the credit agencies will actually upgrade the credit scores for this company? Their credit ratings, excuse me.

A. I think there is a chance that they would. There's certainly a drastically reduced risk of a downgrade, which is the greatest concern, but I think there's also a chance of an upgrade.

And I don't want to leave you with false hope here that such an upgrade would happen in the next six months or so. I think it would happen if, over time, the earned returns are solid. And by solid I mean up there in the 8, 8.5, 9, 9.5, 10 percent range, and if these metrics start moving higher where more of them are up in the intermediate to modest category rather than down in the aggressive to highly leveraged category. So they're going to look at all of that. And enough time passes, I think you might see some upward movement within the Baa or BBB category.

Q. But it is fairly certain to say that if, in fact, the metrics do move more favorably that the likelihood of a downgrade is less. Wouldn't that be fair?

A. Absolutely. There's no question about the direction. What makes it a little hard is to predict the specific what is the probability of a downgrade and what is the probability of an upgrade. That's where I hesitate. But the direction is clear, and I believe the movement and the things that are happening in this agreement are substantial enough that if it emerges from this process and is sustained by the Commission intact that it will definitely help.

Q. And Dr. Johnson, moving on, there were some questions posed to you about regulatory lag. You talked about some of the benefits to ratepayers. But in some instances regulatory lag also works in the favor of the shareholders; isn't that true?

A. Yes.

Q. Could you just provide a couple of examples of that?

A. Well, in general, the -- well, the first example is companies sometimes are in a position to control the timing of rate cases. So they can file a rate case right after a major generating plant has been built, for example. And then in the years thereafter, that's sort of a worst moment in time where you have got the full cost of that plant and the full depreciation and all of the things, the burden you have to deal with. And then the construction program may diminish and their growth continues. And so as they sell more power to customers, there's actually what is called accretion, which is the opposite of attrition. So over time their earnings go up.

So in that context, the lag between rate cases, the fact it's going to take several years before you can really observe that pattern is to their advantage, and they get an opportunity to earn more potentially than their targeted rate of return during that period.

And when we talk about an authorized rate of return, it's not that there's an exact ceiling and nobody can ever earn more than their authorized return. If you look around the country, there are many companies that have sustained returns in excess of the allowed or authorized return for years in a row. There's probably more companies that have earned less, but it does go both ways.

Q. Okay. And then the last area I wanted to touch upon with you, Dr. Johnson, is on cost of equity. One of the concerns Commissioner Pierce has, at least from what I'm hearing, is that when Wall Street looks at what other companies -- excuse me -- what other commissions in other states are awarding for cost of equity, they're not actually getting an apples-to-apples comparison to what is being done here in Arizona because of Arizona's fair value requirement.

Is it your belief from what I'm hearing you testify that this should not really be a great concern because of the credit agencies' focus more on earnings rather than cost of equities?

A. Certainly, the cost of equity has a certain symbolism to it, so it's an easy number to compare. You can get a list of all of the different state orders for any time period, do a little of bit of research, make some phone calls, or go find one of the folks who compile those and publish it, and you can put together an analysis and judge in a single number in a tiny little snapshot some sense of each regulatory jurisdiction, because they're all trying to estimate the same basic phenomena.

There's always going to be company to company differences, and there might even be differences from state to state in the risks in the regulatory environment that cause costs to be a little higher in one state than another, but most of the differences you see, if you see 14.5 allowed in a certain jurisdiction and you see 10 in another, a large portion of that 4 percent spread is the difference in the opinions of the decision-makers. The judges in one state are persuaded by arguments that are not persuasive to the judges in the other state. They probably both are similar arguments. They may even have the same witnesses in front of them, because some of these witnesses travel around, and they just reach a different decision. So in that sense, it has a certain symbolic value, but it's relatively minor.

What is far more significant is the totality of the environment and how long does it take from the time you file a rate case to when the decision is made. And in that category, Arizona is probably one of the longer timelines.

Other issues, well, are they willing to do CWIP in rate base? Not very many states are, but some are.

So, obviously, a state that is, is viewed as more favorable.

But then you have other issues and it's a whole series of issues. And as you look at each one of those, those are sort of the qualitative factors that Wall Street analysts, whether they be, you know, advising whether to invest in a company's stock or to invest in bonds, either one would be the same process.

But ultimately, all of that is in some sense only one part of the picture. The bottom line matters a lot. If you earn 11 or 12 percent in one company and another company is only earning 8 or 9, obviously the stock that's earning 11 or 12 is more attractive than the one that is only earning 8 or 9.

So that was the point I was trying to make earlier about whatever number this Commission puts in the order, whether they put 11 or 12 or, you know, explain both the numbers, it might help a little bit to communicate their story, but ultimately the Commission's story to Wall Street of what they're trying to do.

I think other language can be just as important. The way the order is worded as to the $700 million, if it's made in clear-cut terms that this Commission sees the benefit of that and is supportive of it and will provide a regulatory environment to sustain that investment, that will make it easier to sell that equity when the time comes.

There's other things that are read between the lines, so to speak, reading the tea leaves of orders besides a number like 11, but ultimately the earned return is also very important.

Q. And you mentioned the 700 million as being one of those things. Off the top of your head, can you think of any other things that would be just as important?

A. I think there's plenty of opportunity in the wording of the order. Let's deal with, say, for example, the benchmarks and the performance. That strong signal -- if this Commission, for example, has a strong commitment to renewable energy and is wanting to be a leader of that and willing to suffer a little bit of short-term pain -- I hope it's only a little. We all hope it's a little, but we all recognize there is some pain of being a leader rather than waiting around.

And in order to get the benefit of being at the front of that curve and in order to get the benefit of learning these technologies and being able to get the benefits of their long-term cost performance sooner than other states, language about that and the fact that there's the support there, and that implies -- and they're going to see right then that that implies a willingness to fund it.

If you are making a commitment to help solar energy, for example, and the commitment is real, then anybody considering investing in bonds is going to feel a lot better than if there's some just sort of a -- the negative side of the thing. In fact, the positive side is that you see the benefits and you're understanding and recognizing that it takes a strong -- a financially strong utility to be on the cutting edge and to have kind of aggressive energy goals that are set forth in this agreement. The Commission seeing that and acknowledging it will be beneficial. The parties can acknowledge it and they did, and certainly RUCO did, but for the Commission to do it ultimately is a lot more important than RUCO.

So there's opportunities here in the order that can make a difference in how Wall Street reacts to the decision to this case, regardless of whether it accepts the agreement or, you know, tinkers around the edges. There's plenty of things the Commission can do to send a signal to Wall Street that they understand the importance of having the ability to finance the construction program for things like solar and things like the DSM programs and the like. That you need a healthy utility to do some of those things.

Q. And Dr. Johnson, finally, you just mentioned this image of the Commission being a leader. Does the settlement agreement encourage or present the Commission as being a leader? Further present the view that the Commission is a leader in the essence -- in terms of renewable resources? I'm sorry.

A. I believe it has the opportunity to do that. The targets that were negotiated in that area are quite aggressive. Some may still say, gosh, you know, they're not aggressive enough because they only go out a few years, but they go out long enough to where there's a clear path that we're on.

And to my mind, getting much farther than 2015 or so, you're really getting into speculative territory. And the balance between these different technologies, which ones are going to start paying off faster is so unknown that to lock into specific percentages for the long-term future in my mind is not needed.

But I believe so. My impression is from listening to the negotiators -- I'm certainly not, you know, a detailed expert on this, but my impression is that these are aggressive and significant and that when they actually come into being, the state is going to enjoy a reputation that I think is well deserved, which is, you know, if you're the sun capital of the world, why not be a leader in something like solar energy. And if you've got opportunities to help encourage people to invest in cost effective programs and to encourage people to do things, why not.

So that commitment is there, but it's -- the difference between the commitment and the reality is what is important. How do you execute is very important, picking the specific projects. You know, there's a lot between the idea of a goal and getting there. And having the company on board, I think, is very important. Having the Commission on board is important as well. The commitment from the Commission is going to be very important.

Q. Of course, that will benefit ratepayers; is that correct?

A. I believe it will in the long haul. And in the short-run, then, obviously, there may be slightly higher bills than if you just went out to get natural gas, which happens to be pretty cheap right now, and not worry about what the price may be five years from now. There's a short-run or a long-run. In the long-run, I think it will be beneficial.

MR. POZEFSKY: Thank you, Dr. Johnson.

Thank you, Your Honor.

CALJ FARMER: Anything further for this witness?

MR. MUMAW: No.

CALJ FARMER: Thank you, sir, for your testimony today.

THE WITNESS: Thank you.

CALJ FARMER: Let's go off the record for a moment.

(A recess was taken from 4:45 p.m. to 4:55 p.m.)

CALJ FARMER: Back on the record.

Chairman Mayes had some questions additional questions for Staff's witness, and just remember that you are still under oath.

ELIJAH O. ABINAH,

recalled as a witness on behalf of ACC Staff, having been previously duly sworn by the Certified Reporter to speak the truth and nothing but the truth, was examined and testified as follows:

FURTHER EXAMINATION

Q. (BY CALJ FARMER) Okay. Her first question is why shouldn't we require the $700 million equity infusion to come in before 2014 given what was said in APS's earnings call?

A. Good afternoon, Your Honor. I wasn't on the APS earnings call, so I don't know what was said, but the agreement called for APS to infuse at least $700 million. And it says beginning July 1 -- I'm sorry. June 1, 2009 through December 31, 2004. It doesn't mean that APS have to wait until December 31, 2004.

Q. '14?

A. 2014. I'm sorry. Thank you. So APS can infuse that equity prior to 2014. The agreement just give them a timeline in which they have to infuse the equity.

Q. If she were here she would ask you: Why shouldn't we have them do it sooner than then?

A. And the reason -- I'm trying to be very cautious not to -- we had that discussion during the negotiation, and I think the rationale is to give APS the flexibility when it is most favorable to APS. We don't want to tie APS to a certain timeline in which they have to go infuse the equity when it's not favorable.

And like I said, I'm trying not to cross the discussion during the negotiation. It's just more flexibility so that the company can go out there and use their best judgment and get the best deal.

Q. Okay. And would you agree that the sooner that all happens the better?

A. As a matter of fact, yes. And I hope it happens sooner than later. I hope there is a better and favorable environment for the company to do it sooner. But like I said, it's just a matter of flexibility.

Q. Okay.

A. For the company to use their best judgment when the market is favorable to the company, when the market is favorable.

Q. What is the value of the stay-out provision given the four year stay-out provision agreed to in TEP's most recent settlement agreement?

A. We thought about that during the negotiation. But we believe each company should be treated differently. As you know, TEP stay out of here for 10 years, and each company have different circumstances. So we believe having a scheduled rate case is appropriate for APS rather than staying out for four years.

Q. Does Staff believe the renewable energy provision in the settlement agreement is mandatory? The provisions are mandatory?

A. I believe so. The reason why I said that is it's an agreement which APS signed on to. And when they sign on to an agreement, Staff believe the company should live up to their end of the bargain. So if they sign up with this agreement, I believe the company should live up to its end of the bargain, so yes.

CALJ FARMER: Thank you. Those are her only questions. Anyone else have more questions?

(No response.)

CALJ FARMER: Thank you for coming back again, and enjoy your vacation or wherever you're going to go.

THE WITNESS: Thank you.

CALJ FARMER: All right. APS ready to call Mr. Rumolo back?

MR. MUMAW: Yes, Your Honor. We'll call Mr. David Rumolo back to the stand.

CALJ FARMER: Just remember, sir, that you're still under oath from your previous testimony.

MR. MUMAW: Again, Mr. Rumolo, just to make sure, you're the same Mr. Rumolo that previously testified as part of a panel concerning Schedule 3 issues?

MR. RUMOLO: Yes, I am.

MR. MUMAW: Mr. Rumolo, I believe pursuant to the procedure that we previously described, I believe on the record, although I do have somewhat an extensive direct of you to address certain points that have either been raised in Commissioner letters or have been deferred to you by other witnesses, I'm going to postpone that for the moment and ask that the witness, I believe, be subject to cross-examination by Mr. Crockett.

CALJ FARMER: Mr. Crockett.

MR. CROCKETT: Thank you, Your Honor. And thank you, Mr. Mumaw. I appreciate your accommodation in this regard.

DAVID J. RUMOLO,

recalled as a witness on behalf of the Applicant, having been previously duly sworn by the Certified Reporter to speak the truth and nothing but the truth, was examined and testified as follows:

CROSS-EXAMINATION

Q. (BY MR. CROCKETT) Mr. Rumolo, do you have the settlement agreement there in front of you?
A. Yes, I do.
Q. I would like you to turn to Section 17, which is on Page 35.
A. I'm there.
Q. You have been here in the hearing room basically through most of the proceeding, have you not?
A. Either here or listening on the Listen Line.
Q. The essence of the questions that I'm going to be asking you have to do with questions that have arisen by virtue of questions posed by various Commissioners that relate to primarily Section 17, which involves revenue spread.
There were a couple of other things that I wanted

to chat with you about, but before you get to addressing revenue spread you have to have a revenue requirement determination, do you not?

A. That's correct.

Q. And are you also required to have a cost of service study?

A. Yes. We compile the financial and sales information and so forth and prepare a fully allocated cost of service study.

Q. And APS did conduct such a study in connection with this proceeding, did they not?

A. Yes, we did.

Q. And was that cost of service study conducted consistent with the Commission's directives in APS's last rate case?

A. Yes, and past practices.

Q. And can you just briefly describe what the purpose of a cost of service study is?

A. Sure. The cost of service study takes the test year investment and expenses and allocates those to each of the customer classes. And in our case, we actually do subgroups of customer classes, generally along the lines of our current rate schedules. And we allocate the expenses and compare that to revenues to determine which classes are paying their cost of service and it provides a guide for rate design.

Q. Okay. And so the design of rates, then, is to recover those costs that are created by the various customer classes; is that correct?

A. That's correct.

Q. In other words, to phrase it, the cost causer should be the cost payer; is that right?

A. Yes. It's a general guideline.

Q. When you are looking at cost, you consider all of the costs that are involved in providing services to the customer classes; is that right?

A. Yeah. We look at allocating capacity costs, energy costs, customer costs and so forth, and assignments to the customer classes.

Q. And when you look at energy costs, you're talking about the generation that's provided by APS as well as purchased power costs; is that correct?

A. We actually separate. We assign generation costs, the fixed costs of our current fleet of generation on a demand basis, and then the fuel and purchased power is allocated on an energy basis.

Q. Okay. And those costs are included in your cost of service study and a determination as to which classes of customers are causing those costs?

A. That's correct.

Q. And insofar as you heard a number of questions that have related to the purchased power adjustor clause and the 90/10 relationship, have you not?

A. Yes, I have.

Q. Isn't it true that the rate case that we're involved in at this particular point in time is to establish a fuel cost factor?

A. Yes. It's establishing a new base fuel cost, and then the PSA as we go forward in time will track the changes against that base.

Q. Either increasing costs or decreasing costs; is that correct?

A. That's correct.

Q. Has APS always had a fuel adjustor clause?

A. The current fuel adjustor clause was the result of our rate case that was, I believe, a 2002 test year and decided in 2005, I believe. There was a time period prior to that where APS did not have a fuel adjustor, but when we go back further in time there was one. So we have had one, did not have one for a period, and then a new one.

Q. And when you don't have a power supply adjustor clause, you have to depend on the cost factors that were established in the last rate case until you have a subsequent rate case; is that correct?

A. Yes.

Q. Now, would you agree that it's been the intent of the Commission to move the rates closer to the cost of providing the service to the various customer classes?

A. Yeah. I think that's an ongoing move that we have is to make the rates better track the cost of service study.

Q. And, in fact, you have also undertaken various tariffs and procedures in order to bring that about, have you not?

A. Yes. And an example of that is what is shown in the settlement agreement where for many, many years we had a rate schedule designated as Schedule E-32 that covered general service customers whose loads were for as small as a billboard up to a pretty good-sized industrial plant to, say, up to 3 megawatts. So we had one rate schedule that covered a big gamut of types of customers.

So we actually started in our -- I belive it was our rate case two times ago to move, at least from an analytical perspective, to take this Rate Schedule E-32 and break it up into smaller components. And in our last rate case decision, I think it was based on a recommendation by Staff, and which we concurred, was that in this case we would take E-32 and break it up into several rate schedules.

Q. Okay. I'm going to come back to that again in just a minute. Now, what about time-of-use rates? Is that not also a tariff that is intended to get the rates closer to costs?

A. Yeah. And actually, all of our rate schedules we attempt to get them closer to costs. For example, on our large industrial rate schedules, we have a fairly significant capacity charge that reflects our capacity costs, then have an energy charge that tends to reflect the losses in fuel and purchased power.

Our TOU rates are designed to try to provide better price signals to customers to shift load off of peak and to -- from peak, from on-peak time periods to off-peak time periods when our costs of providing primarily generation are lower.

Q. That is one of the reasons that you're attempting to have the cost causer become the cost payer, right?

A. Yeah. It's really the price signal, because it helps customers make better decisions.

Q. Coming to Section 17.1, there have been a number of questions that have been raised by both Commissioner Newman and Commissioner Pierce concerning the provision in that section that each retail rate schedule will receive an equal percentage total base rate increase inclusive of the interim rate increase and inclusive of fuel and purchased power costs that are incorporated into rate base.

That is a provision that was included in the direct testimony of APS, is it not?

A. In our settlement testimony we discussed that, and we had also discussed rate design vis-à-vis cost of service in our original application.

Q. And did you not propose in your direct testimony and your original application that there be an equal percentage increase across all customer classes?

A. Generally speaking, yes, although there were refinements around that.

Q. But in general that was the proposal that APS made, was it not?

A. Yes.

Q. And would you also agree that that was, in essence, Staff's proposal as well?

A. I don't recall Staff's proposal.

Q. You know that that is the proposal of AECC; is that correct?

A. Would you repeat that, please?

Q. You do know that AECC proposed that there be an equal percentage total base rate increase across all classes of customers?

A. Generally speaking, that's correct. And I think Mr. Higgins had also proposed that we fine tune the rates that were in E-32.

Q. There were a couple of exceptions to that. One was the E-32, which you previously had discussed. And you have heard the questions posed by Commissioner Pierce with reference to the E-32 classification?

A. Yes.

Q. The E-32 classification in general did receive an equal percentage increase, did they not?

A. The entire group of E-32 customers did.

Q. Along with other customer classes?

A. Yes.

Q. And then within that classification, as you have already alluded to, it was broken up into basically four different groups, was it not?

A. Yes, they were size differentiated.

Q. And the cost of service study that was conducted by APS indicated that there should be some modest changes with reference to the various classes, some receiving a little greater than the average and some receiving a little less than the average?

A. That's correct.

Q. But all still within the same equal percentage increase that other rate classifications were receiving as well?

A. Yes.

Q. And with reference to that, there was another exception as to the class of customers receiving an equal percentage increase, was there not?

A. Yes. Per the terms of the settlement agreement, the low income customers were held exempt or held harmless from rate changes under the settlement agreement.

Q. So there was a similar type of a change or a structure within the residential classification in that all customers within that classification didn't receive the equal percentage increase; is that right?

A. There was the carve-out for the low income and medical discount customers, which is Schedule E-4, although most people are on E-3.

Q. And the low income class of customers also was held harmless from the increase in the demand side adjustor clause; is that correct?

A. That's correct. And also from the PSA, which has been a feature for quite some time.

Q. Coming now to the issue of the 90/10 split between customers and APS, apparently there has been some confusion on the part of the Commissioners in that regard.

Is it your understanding that Mr. Higgins testified that that split should be done away with?

A. No. In our case, in the APS case, the settlement agreement maintains the 90/10 sharing. I think there may be some confusion. In the TEP case, there is no 90/10 sharing.

Q. Okay. But I think I may have misunderstood Commissioner Newman's question in that regard, but I think I understood him to indicate that Mr. Higgins was recommending that that split be done away with insofar as the APS case is concerned. That's not your understanding; is that correct?

A. I don't recall that, no.

Q. The settlement agreement does provide that that 90/10 split is to be continued, does it not?

A. That's correct.

Q. Commissioner Newman also raised the issue of the transmission cost adjustor rate. Do you recall his testimony in that regard?

A. On the TCA, yes, I do.

Q. Can you briefly explain how the transmission cost adjustor rate is established?

A. Yes. The revenue requirements are assigned based on the class contribution to the four coincident peaks, the four maximum loads during our summer months. And the TCA, then, is allocated in that manner, and then each customer group then develops their own cost responsibility.

In the case of a residential customer, those dollars are converted to a per kilowatt charge. For the large customers it is on a demand basis. And it truly is cost of service based. There's no cross-class subsidy. It is cost of service based.

Q. Is it not a fact that that allocation method was established in APS's last rate case?

A. Actually, the 4-CP allocation was established quite a few years ago at the FERC level. For allocating generation costs from our last case, we changed to an average and excess demand method for generation. Transmission is 4-CP; generation is on average and excess demand.

Q. Okay. The rate for transmission is established by FERC; is that correct?

A. Yes. Under our formula rate methodology, it establishes the rates that are found in the OATT, the Open Access Transmission Tariff.

Q. And FERC doesn't allocate that among the various classes or within the individual states; is that correct?

A. It's actually allocated within the formula to classes, because the OATT was established to develop costs or rates to charge customers whether they are a retail residential customer that is taking standard offer service from APS, or from an energy service provider, an ESP.

Q. But wasn't that allocation method established by agreement of the parties in APS's last rate case?

A. What happened in our last rate case, when the transmission costs were originally allocated two or three rate cases ago, I believe, they were allocated on a per kilowatt hour basis. In our last rate case, we redesigned the rates so they would, for the customers with demand meters, would be recovered on a demand basis to better track the OATT charges.

Q. Okay. And those charges, insofar as the individual customer classes are concerned, can change from time to time, can they not?

A. Yes. In our next formula rate, if the relationship between peak contributions between residential and general service or large industrial customers changes, it would be still reflected in the TCA filing.

Q. And those TCA costs that have recently been allocated are consistent with an order that was entered by this Commission in connection with APS's last rate case; is that correct?

A. Yeah, and recovered in accordance with that.

MR. CROCKETT: Thank you, Mr. Rumolo. I have no further questions.

CALJ FARMER: Well, it's 5:20. Why don't we go ahead and stop here for today, and we're going to reconvene on Wednesday. Let's start at 9:00 a.m. again on Wednesday, and you'll be back on the stand, Mr. Rumolo, on Wednesday.

THE WITNESS: Again and again, I think.

CALJ FARMER: Right. And I know that Ms. Pecora has questions for you, but she's not going to be here on Wednesday. So we'll need to see you sometime on Thursday, too, even if you do, per chance.

THE WITNESS: I will be here.

CALJ FARMER: Anything else we need to put on the record, Mr. Robertson?

MR. ROBERTSON: Is Wednesday one half day or a full day?

CALJ FARMER: It will be a half day. I think that the Commission has scheduled a Staff open meeting for 2:00. So we may go like until 12:30 or maybe even possibly 1:00, but I can't predict how long those Staff meetings last, so we'll stop then.

MR. ROBERTSON: Thank you.

CALJ FARMER: Thank you. Anything else?

(No response.)

CALJ FARMER: All right. Thank you very much.

(The proceedings recessed at 5:18 p.m.)

INDEX TO EXAMINATIONS

INDEX TO EXHIBITS

NO.	DESCRIPTION	IDENTIFIED	ADMITTED
P-12	Testimony of Bobby Miller	1856	1871
S-4	Direct Testimony of Kenneth Strobl	1899	1903
S-18	APS Lineman Fatality Document	1901	1903

STATE OF ARIZONA)
) ss.
COUNTY OF MARICOPA)

WE, COLETTE E. ROSS and MICHELE E. BALMER, Certified Reporters Nos. 50658 and 50489 for the State of Arizona, do hereby certify that the foregoing printed pages constitute a full, true and accurate transcript of the proceedings had in the foregoing matter, all done to the best of our skill and ability.

WITNESS my hand this 15th day of September, 2009.

Colette E. Ross

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