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BEFORE THE ARIZONA CORPORATION RECEIVED

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IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE COMPANY FOR A
HEARING TO DETERMINE THE FAIR VALUE OF
THE UTILITY PROPERTY OF THE COMPANY
FOR RATEMAKING PURPOSES, TO FIX A JUST
AND REASONABLE RATE OF RETURN
THEREON, TO APPROVE RATE SCHEDULES
DESIGNED TO DEVELOP SUCH RETURN

DOCKET NO. E-01345A-08-0172
MESQUITE GROUP'S
POST-HEARING BRIEF

Pursuant to the directive of Chief Administrative Law Judge Lyn Farmer, Mesquite Power, L.L.C., Southwestern Power Group II, L.L.C. and Bowie Power Station, L.L.C. (collectively "Mesquite Group") hereby submit their Post-Hearing Brief in the above-captioned and above-docketed proceeding.

I. INTRODUCTION

A. Background Overview.

The Mesquite Group is comprised of three (3) entities: (i) Mesquite Power, L.L.C., which has owned and operated a 1,250 MW natural gas-fired combined cycle generating facility near Arlington, Arizona since 2003; (ii) Bowie Power Station, L.L.C., which has received a Certificate of Environmental Compatibility and related authorizations to construct a 1,000 MW natural gas-fired combined cycle generating facility near Bowie, Arizona, and (iii) Southwestern Power Group II, L.L.C., the Project Manager for the SunZia Transmission Project, a proposed 460 mile, double-circuit 500 kV transmission facility, which will enable the transmission of electricity into Arizona from renewable energy generation facilities located in New Mexico.

1 Tucson Electric Power Company and the Salt River Project are also participants in the SunZia Transmission Project.

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1 The members of the Mesquite Group participate as actual and prospective sellers in the
2 competitive wholesale power supply market in Arizona. Originally, their participation relied
3 upon conventional sources of generation, such as natural gas-fired combined cycle electric
4 generation facilities. In more recent years, the members of the Mesquite Group (or affiliated
5 entities) have begun to include generation projects which utilize renewable energy technology in
6 their respective business plans and marketing activities.

7 Arizona Public Service Company ("APS") has been and continues to be a major
8 participant and purchaser in the competitive wholesale power market in Arizona. As a
9 consequence, APS' financial condition, as reflected in its credit metrics and bond ratings, is of
10 substantial interest and concern to the members of the Mesquite Group. Simply stated, APS'
11 creditworthiness (or lack thereof) has a direct and substantial bearing (i) upon whether potential
12 sellers, including the members of the Mesquite Group, are able to extend long-term credit
13 arrangements to APS; and, if so, (ii) upon what terms and conditions. In that regard, the
14 members of the Mesquite Group have actively participated in all of APS' emergency and
15 permanent rate cases since 2003.

16 In addition, APS' creditworthiness is also of critical importance to its ratepayers, its
17 shareholders and the State of Arizona as a whole. As the evidentiary record in this proceeding
18 discloses, APS does not own enough generation resources to fully satisfy the requirements of its
19 customers for electric service. APS witness Guldner characterized this as a "net short position"
20 for the company. As a consequence, APS must look to the competitive wholesale electric market
21 to supply a significant portion of its electric power resource requirements, and that situation is
22 likely to continue for the foreseeable future. In that regard, APS has financial and practical
23 limitations upon the amount of debt and equity it can issue at any given point in time; and, its
24 capital expenditure needs are not confined to electric generation facilities. Rather, they include
25 transmission (including substation) and distribution facilities as well.

1 **B. Mesquite Group's Settlement Objectives and Position.**

2 A major objective of the Mesquite Group in this case was to achieve an end result which
3 would place APS in a sound financial position, consistent with the interests of APS' ratepayers
4 and shareholders, thereby ending the pattern of annual rate proceedings and financing instability
5 which has surrounded APS in recent years. A second and related major objective was to retain
6 that policy statement recognition of the importance of the competitive wholesale power market
7 to Arizona's energy future, which the Commission established in the Track "A" and Track "B"
8 proceedings in 2001, and has reiterated on a number of occasions since then. As the Commission
9 is aware, sometimes the most appropriate power resource choice for an electric utility is a long-
10 term Purchased Power Agreement ("PPA") or the acquisition of a developer-build project. Other
11 times, the most appropriate choice may be a self-build decision by the utility. However, each of
12 these power resource options requires a financially sound electric utility.

13 The Mesquite Group believes that the June 12, 2009 Settlement Agreement which is now
14 before the Commission provides for the realization of the aforesaid two (2) objectives, as well as
15 many of the objectives of the twenty-one (21) other signatory parties.² Significant in that regard,
16 is the explicit recognition in Paragraphs 1.4, 1.7, 1.15 and 3.4 of the Settlement Agreement of the
17 direct relationship between APS' financial condition and its ability to avail itself of favorable
18 purchase opportunities in the competitive wholesale power market, incident to the company
19 positioning itself to better serve its customers' future electric service needs.³

20 **C. Scope of Mesquite Group Brief.**

21 As noted above, there are a total of twenty-two (22) signatory parties to the Settlement
22 Agreement. Only one (1) party of the record did not execute the document, and her interest area

23 _____
24 ² Pursuant to the Procedural Order issued on April 25, 2009 in this proceeding, the Mesquite Group filed the
25 prepared Direct Testimony of Leesa Nayudu in support of the Settlement Agreement. Ms. Nayudu is the Director of
26 Origination for Sempra Generation, which owns Mesquite Power, L.L.C.; and, she also was testifying on behalf of
27 Bowie Power Station, L.L.C. and Southwestern Power Group II, L. L.C. In that regard, Ms. Nayudu's testimony
28 specifically addressed Sections I (Recitals), II (Rate Case Stability Provisions), VIII (Equity Infusions), XIII
(Periodic Evaluation) and XV (Renewable Energy) of the Settlement Agreement; and, it was received into evidence
as Exhibit Mesquite-1 in the instant proceeding. A copy of that exhibit is attached to this Post-Hearing Brief as
Appendix "A," and is incorporated herein by this reference.

³ The existence of this direct relationship was also acknowledged by APS witnesses Hatfield and Guldner,
Commission Staff witness Abinah and RUCO witness Johnson during their respective cross-examination by counsel
for the Mesquite Group.

1 is of a discrete nature within the overall context of the Settlement Agreement, albeit an important
2 one. Given the multitude and complexity of questions addressed and resolved through the
3 settlement negotiation process, as well as the number of parties and diversity of interests
4 involved, the Settlement Agreement now before the Commission represents a remarkable
5 accomplishment. In the opinion of the signatory parties, the Settlement Agreement also
6 represents what they believe is a balancing of sometimes competing specific interests which is
7 consistent with the general "public interest."⁴

8 In this Post-Hearing Brief, the Mesquite Group discusses those aspects of the Settlement
9 Agreement which it believes it is best in a position to offer informed comment upon. It will
10 defer to other Signatory Parties to address those aspects or matters which are of particular
11 importance to them and/or within their respective areas of competence or expertise.

12 **II.**
13 **DISCUSSION**

14 **A. APS' Creditworthiness.**

15 As previously noted, Paragraphs 1.4, 1.7, 1.15 and 3.4 of the Settlement Agreement
16 explicitly recognize, and the testimony of several parties also acknowledges, the direct
17 relationship between APS' financial condition and its ability to avail itself of favorable purchase
18 opportunities in the competitive wholesale power market, incident to the company positioning
19 itself to better service its customers future electric service needs. Various provisions throughout
20 the Settlement Agreement are intended to address and significantly improve the "financial
21 condition" aspect of this relationship. Those provisions include the following:

- 22 1. A rate case stability plan which covers the period of January 1, 2010 through
23 December 31, 2014 [Section II, Paragraphs 2.1 through 2.5];
- 24 2. A \$196.3 million non-fuel Base Rate Increase, inclusive of the \$65.2 million interim
25 increase granted in 2008 [Section III, Paragraphs 3.1 through 3.4]; plus, an additional
26 increase of \$137.2 million in base fuel costs [Section III, Paragraph 3.6];

27
28 ⁴ Paragraph 1.16 of the Settlement Agreement summarizes the twenty-three (23) benefits which the Signatory Parties believe the Settlement Agreement provides, and they are listed in six (6) different subject matter categories.

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3. The commitment of APS to reduce its expenses on an annual average basis by \$30 million for the period of January 1, 2010 through December 31, 2014. [Section VII, Paragraphs 7.1 through 7.4];
4. The commitment of APS to complete equity infusions of at least \$700 million between June 1, 2009 and December 31, 2014 [Section VIII, Paragraph 8.1];
5. The commitment of APS to use its best efforts to (a) maintain investment grade beneficial ratios and a balanced capital structure, and (b) improve its financial metrics and bond ratings [Section VIII, Paragraphs 8.2 and 8.3];
6. The commitment by APS to prepare and submit to the Commission and the Signatory Parties, within 120 days from Commission approval of the Settlement Agreement, a plan detailing the measures APS intends to take to maintain and improve its financial ratings with the credit rating agencies [Section VIII, Paragraph 8.4];
7. The allowed deferral by APS for future recovery of a portion of its annual Pension and OPEB costs above or below the test year level in 2011 and 2012, subject to the limitations specified in the Settlement Agreement [Section IX, Paragraphs 9.1 through 9.5];
8. The treatment of Schedule 3 funds received by APS as revenues during the period from January 1, 2010 through the earlier of December 31, 2012 or the conclusion of APS' next general rate case [Section X, Paragraphs 10.1 through 10.7];
9. The prospect of an adjustment of depreciation rates associated with an extension of the operating license for the Palo Verde Nuclear Generation Station [Section XI, Paragraphs 11.1 through 11.5]; and,
10. The Performance Measures, Reporting Requirements and Benchmarking Study provisions of the Settlement Agreement, which will augment the opportunity to improve its financial soundness afforded to APS by virtue of the Settlement Agreement as a whole [Section XIII, Paragraphs 13.1 through 13.5].

1 Because of the foregoing provisions, the Mesquite Group believes that Commission
2 approval of the Settlement Agreement would afford APS with an opportunity to materially
3 improve its current financial condition (and resultant creditworthiness) in a manner that is
4 consistent with the best interests of APS' ratepayers, APS' investors and those who seek to do
5 business with APS, such as the Mesquite Group. Moreover, APS would be provided with the
6 opportunity to maintain such improvements over time and hopefully end the cycle of frequent
7 general rate cases that has been the pattern in recent years. At the same time, as discussed in
8 Subsection II(B) below, the Mesquite Group believes that the Settlement Agreement provides the
9 Commission and the Signatory Parties with meaningful means for monitoring and measuring the
10 manner and extent to which APS undertakes to maximize such opportunity.

11 **B. Monitoring and Measuring APS' Performance Prospectively.**

12 As noted in Section I(A) above, the Mesquite Group has actively participated in all of
13 APS' emergency and permanent rate cases since 2003, which were characterized by a pattern of
14 annual proceedings surrounded by financial instability. Against that background, the Mesquite
15 Group participated in the settlement negotiations in this proceeding with a desire to end that
16 pattern and place APS on the path to a financially sound condition. However, at the same time,
17 the Mesquite Group was firmly of the view that (i) it was incumbent upon APS to assume a
18 major role in rectifying its present financial circumstances; and, (ii) the Settlement Agreement
19 should expressly codify APS' responsibilities in that regard, and provide various means for
20 monitoring and measuring its progress. In this manner, the improvement of APS' financial
21 condition and creditworthiness could be the result of a balance of combined actions by the
22 Commission and the Company.

23 The Mesquite Group believes that the Settlement Agreement which resulted from the
24 settlement negotiations achieves that balance, and that it provides means by which APS'
25 discharge of its responsibilities may be monitored and measured prospectively by the
26 Commission and the Signatory Parties. Significant provisions in that regard include the
27 following:
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1. The commitment of APS to reduce its expenses on an annual average basis by \$30 million for the period of January 1, 2010 through December 31, 2014. [Section VII, Paragraphs 7.1 through 7.4];
2. The commitment of APS to complete equity infusions of at least \$700 million between June 1, 2009 and December 31, 2014 [Section VIII, Paragraph 8.1];
3. The commitment of APS to use its best efforts to (a) maintain investment grade beneficial ratios and a balanced capital structure, and (b) improve its financial metrics and bond ratings [Section VIII, Paragraphs 8.2 and 8.3];
4. The commitment by APS to prepare and submit to the Commission and the Signatory Parties, within 120 days from approval of the Settlement Agreement, a plan detailing the measures APS intends to take to maintain and improve its financial ratings with the credit rating agencies [Section VIII, Paragraph 8.4];
5. The Performance Measures, Reporting Requirements and Benchmarking Study provisions of the Settlement Agreement, which will augment the opportunity to improve its financial soundness afforded to APS by virtue of the Settlement Agreement as a whole [Section XIII, Paragraphs 13.1 through 13.5].

In connection with the above, the Commission and the Signatory Parties will be able to ascertain the extent to which APS endeavors to maximize the opportunity provided to it, in the event of Commission approval of the Settlement Agreement; and, they will be in a position to discern the degree of success of APS' efforts. In addition, they will be in a position to examine the appropriateness of measures proposed to be undertaken, and actually undertaken, by APS to discharge its responsibilities under the Settlement Agreement.

The following examples are illustrative in that regard. Paragraphs 8.4 and 13.2(g) of the Settlement Agreement require that APS prepare and submit a plan detailing the measures it intends to take to maintain and improve its financial ratings with the credit rating agencies. Copies of this plan are to be provided to both the Commission and the Signatory Parties. As a consequence, recipients of copies of the plan will have an opportunity to offer comment in

1 advance of implementation as to their perception of the adequacy and appropriateness of APS'
2 intended measures. This is markedly different from the current situation, where knowledge of
3 APS' intent and/or actions is sometimes obtained after-the-fact.

4 Similarly, the annual Financial Reporting requirements of Paragraph 13.4(b) of the
5 Settlement Agreement will provide the Commission and the Signatory Parties with a significant
6 amount of information on an ongoing basis relating to APS' financial performance moving
7 forward, and the extent to which it is achieving progress towards the financial and capital
8 structure targets established for it in the Settlement Agreement. Again, the Commission and the
9 Signatory Parties will have an opportunity to offer "interim" comment if they so desire, rather
10 than having to wait until APS' next rate case.

11 Finally, and of particular interest to the Mesquite Group, Paragraph 13.4(b)(xii) of the
12 Settlement Agreement provides that APS' annual Financial Reporting filing shall include

13 "Information regarding the Company's level of major capital
14 expenditures, and its consideration of available alternatives in
15 connection with such expenditures for generation facilities."
16 [emphasis added]

17 The Mesquite Group believes that information of this nature will enable both the Commission
18 and the Signatory Parties to ascertain whether (i) APS is making appropriate capital expenditure
19 decisions of this nature, and (ii) APS is complying with applicable Commission decisions and
20 procurement or resource planning regulations. As noted in Section I(B) above, the Commission
21 has recognized the importance of a competitive wholesale power market to Arizona's energy
22 future for a number of years. This provision of the Settlement Agreement will assist in
23 maintaining the ongoing viability of that market.⁵ In addition, it should assist in insuring that
24 APS makes prudent decisions in connection with the allocation of available funds for competing
25 capital expenditures (generation vs. transmission vs. distribution), given (i) the limitations of
26 funding from debt and equity issues available to APS at any point in time, and (ii) the availability
27 of generation resources through PPAs.

28 ⁵ In that regard, the requirement in Paragraph 15.3 of the Settlement Agreement that APS "initiate a competitive
procurement" in the manner therein contemplated, in connection with the "utility scale photovoltaic generation"
project which is the subject of Paragraph 15.3, is consistent with this policy position of the Commission.

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1 for filing this 7th day of October 2009 to:

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5 A copy of the foregoing Post-Hearing Brief will
6 be mailed or emailed on October 9, 2009 to:

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