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BEFORE THE ARIZONA CORPORATION COMMISSION

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Arizona Corporation Commission

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AZ CORP COMMISSION  
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2 COMMISSIONERS

- 3 KRISTIN K. MAYES, Chairman
- 4 GARY PIERCE
- 5 PAUL NEWMAN
- 6 SANDRA D. KENNEDY
- 7 BOB STUMP

8 IN THE MATTER OF THE APPLICATION OF  
 9 ARIZONA PUBLIC SERVICE FOR A  
 10 HEARING TO DETERMINE THE FAIR  
 11 VALUE OF THE UTILITY PROPERTY OF  
 THE COMPANY FOR RULEMAKING  
 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

**COMMISSION STAFF'S  
POST-HEARING BRIEF**

12 **I. INTRODUCTION**

13 Extraordinary circumstances call for extraordinary measures. The circumstances that  
 14 presented themselves in this case were unique. Arizona Public Service Company ("APS" or  
 15 "Company") S&P bond rating has inexplicably hovered above junk levels for several years now.  
 16 This has resulted in serial rate case filings, which in recent years have been preceded by requests for  
 17 emergency relief. Yet, despite all of the measures that the Commission has taken in recent years to  
 18 help the Company, APS remains in the lower rung of S&P's investment grade rankings. And, it  
 19 appeared that nothing could explain or resolve the problem with APS and the investment community.  
 20 Left unresolved, however, the problem could eventually become much more grave with APS  
 21 downgraded to non-investment levels at a significant cost ratepayers. The Company's financial  
 22 position was made even more precarious by the financial meltdown on Wall Street that occurred  
 23 during the interim phase of this case.

24 Because APS provides electric service to more than 1 million customers in 11 of Arizona's 15  
 25 counties, the Staff believed it critical to use this opportunity to structure a comprehensive package  
 26 that addressed the Company's underlying problems as well as other issues of importance.

27 The Proposed Settlement Agreement ("SA" or "Agreement") is the parties' best effort to  
 28 resolve APS' problems with the investment community and to put the Company on the path to

1 financial stability which is in the long-term best interest of ratepayers. It also furthers important  
 2 policy objectives of the Commission in the areas of Demand Side Management and Renewable  
 3 Energy. The Proposed Agreement is endorsed by twenty-two of the twenty-four parties to this  
 4 proceeding, including the Utilities Division Staff ("Staff"). The Proposed Agreement is the product  
 5 of many hours of intense negotiation between parties with diverse interests.

6 If adopted, the parties are hopeful that the Proposed Agreement will accomplish what the last  
 7 four to five litigated rate cases have been unable to accomplish: improvement in the Company's  
 8 financial standing with the investment community, more predictability with respect to rate case  
 9 filings, and a stronger commitment by the Company in Arizona's energy future.

10 Staff and the other Signatories believe that they have developed a settlement package that  
 11 balances APS' rate increase with benefits for customers. These benefits were set out in the Proposed  
 12 Agreement at pages 8-10 and while reiterated throughout this case, Staff believes they deserve  
 13 mention again:

14 **A. Investments in Arizona's Energy Future.**

- 15 • Establishment of energy efficiency goals and the creation of tiered  
 16 performance incentives to encourage meeting those goals;
- 17 • At least 100 schools served by DSM programs and at least 1,000 customers in  
 18 existing homes served by the Home Performance enhanced program element  
 19 by December 31, 2010;
- 20 • Placement of renewable energy projects at Arizona schools and government  
 21 institutions;
- 22 • A plan for utility scale photovoltaic generation and an RFP for in-state wind  
 23 generation;
- 24 • Additional renewable energy projects to be in place by 2015 which, in  
 25 combination with existing renewable commitments, will result in  
 26 approximately 10% of APS' retail sales coming from renewable resources;  
 27 and,
- 28 • Construction of one or more renewable energy transmission facilities;

29 **B. Commitments Benefiting Low-Income Customers.**

- 30 • Continued rate discounts for low income ratepayers, holding these ratepayers  
 31 harmless from the rate increase;
- 32 • Creation of a new bill assistance program to benefit customers whose incomes  
 33 exceed 150% of the Federal Poverty Income Guidelines but are less than or  
 34 equal to 200% of the Federal Poverty Income Guidelines, funded by APS; and,

- Waiving additional security deposits for low income ratepayers.

**C. Rate Stability Provisions.**

- An increase in rate stability, including an extended period without base rate increases and a scheduled plan for future rate cases, resulting in greater administrative efficiency and reduced uncertainty for both APS and ratepayers.

**D. Rate Related Benefits.**

- An improvement in APS' ability to attract capital, maintain reliability and sustain growth;
- A limit on recovery through rates of executive incentive compensation based upon performance;
- A sustained reduction of expenses of at least \$30 million per year, which will reduce the need for future rate increases;
- An infusion of at least \$700 million of additional equity and an improvement in APS' financial metrics, strengthening its bond rating and reducing future debt costs;
- A plan to be prepared by APS to maintain investment grade financial ratios and improve APS' financial metrics;
- An acceleration of the refund of any over-collected amounts in the PSA account, resulting in a lower adjustor rate that will partially offset the base rate increase;
- A reduced Systems Benefits Charge in 2012 if a Palo Verde license extension is approved before the conclusion of the next rate case; and,
- Continued 90/10 sharing of the PSA.

**E. Creation of Performance Measures for APS.**

**F. New Rate Design Options.**

- Creation of an optional super-peak tariff for residential customers and other critical peak pricing rates;
- Twelve month reopening of the E-20 House of Worship tariff;
- Development of Interruptible Rate Schedules and other Demand Response Programs for large customers; and,
- A new optional time of use rate for schools.

Staff believes that the benefits from the Proposed Agreement are significant and that the record evidence supports adoption of the Agreement.

1 **II. BACKGROUND.**

2 **A. Procedural History.**

3 On March 24, 2008, APS filed an application for a rate increase. The Company filed an  
4 Amended Application on June 2, 2008. On June 6, 2008, the Company also filed a Motion for  
5 Interim Rates and Preliminary Order.

6 The following entities moved for and were granted intervention in the case: AZAG Group,  
7 the Arizona Association of School Business Officials ("AASBO"), the Arizona Investment Council  
8 ("AIC"), the Arizona School Boards Association ("ASBA"), Arizonans for Electric Choice and  
9 Competition ("AECC"), Bowie Power Station, LLC ("Bowie"), Cynthia Zwick, the Federal  
10 Executive Agencies ("FEA"), Freeport-McMoRan Copper & Gold Inc. ("Freeport-McMoRan"),  
11 IBEW Locals 387, 640 and 769, Interwest Energy Alliance ("Interwest"), the Kroger Co. ("Kroger"),  
12 Mesquite Power, LLC ("Mesquite"), the Residential Utility Consumer Office ("RUCO"), Southwest  
13 Energy Efficiency Project ("SWEEP"), Southwestern Power Group, LLC ("SWPG"), Town of  
14 Wickenburg, and Western Resource Advocates ("WRA"), the Hopi Tribe and Ms. Barbara Wiley  
15 Pecora. In addition, the Arizona Corporation Commission ("Staff") Staff was also an active  
16 participant in the case.

17 **B. The Interim Case.**

18 In its request for interim relief, the Company sought an interim rate increase of approximately  
19 \$115 million or nearly 4 mills per kWh, effective with the first billing cycle of November 2008. That  
20 amount was to coincide with the loss of revenue due to a roll-off of the Company's 2007 Power  
21 Supply Adjustor charge of \$0.003987 per kWh, approved in Decision No. 69663.

22 In its Motion, APS asserted that its earning and cash flow were inadequate to finance its  
23 capital needs, and so it must borrow huge sums to keep up with the needs of APS customers. It  
24 claimed that it made investments of around \$1.7 billion since the end of the test year in its last rate  
25 case and continued to have a very aggressive construction budget. The Company also claimed  
26 significant increases in the cost of raw materials. It further claimed that its inability to earn on this  
27 investment is leading to sagging earnings for both Pinnacle West (its parent corporation) and APS. It  
28

1 also claimed that because of this, there was a 75 to 100% chance that S&P would downgrade the  
2 Company's credit rating from BBB minus to BB plus or non-investment grade levels.

3 During this same time, in the fall of 2008, pre-existing difficulties in the subprime mortgage  
4 market escalated, resulting in one of the most severe financial crises in the debt and equity markets  
5 this country has seen.

6 On December 24, 2008, the Commission granted APS interim rates in the amount of \$65.2  
7 million in Decision No. 70667. The increase was implemented through an interim base rate  
8 surcharge of \$0.00226 per kWh effective with bills issued after December 31, 2008. Those rates  
9 remain in effect until a final order is issued by the Commission in APS' pending permanent case.

10 **C. The Permanent Case.**

11 The procedural schedule on the Company's permanent case set the deadline for Staff and  
12 Intervenor non-rate design direct testimony on December 19, 2008. On that date, testimony was filed  
13 by Staff, RUCO, AECC, IBEW 387, 640, and 769, Cynthia Zwick, SWEEP, WRA, ASSBO, and  
14 ASBA. Staff and Intervenor direct testimony on rate design issues was filed on January 9, 2009.

15 APS proposed a total rate increase of \$448 million. Staff proposed a total rate increase of  
16 approximately \$307 million. RUCO proposed a total rate increase of \$157 million. AECC's  
17 testimony would have resulted in a total rate increase of \$347 million.

18 APS filed a notice of settlement discussions on January 23, 2009. The parties to the  
19 proceeding subsequently held settlement discussions. On January 30, 2009, APS filed a Motion to  
20 Suspend the Procedural Schedule. A procedural conference was held on April 7, 2009 and again on  
21 April 21, 2009, at which the Staff, APS and other participating Intervenors indicated that they had  
22 reached an agreement in principle on the revenue requirements issues and that substantial agreement  
23 had been reached on the other issues.

24 On May 4, 2009, the Settling Parties filed a Term Sheet outlining their agreement in principle.  
25 A bill impact analysis statement was filed by the Settling Parties on May 15, 2009. The Proposed  
26 Settlement Agreement was filed by the parties on June 12, 2009.

27 A procedural order was issued on May 11, 2009 establishing deadlines for the filing of  
28 testimony on the Proposed Agreement and an evidentiary hearing commencing on August 19, 2009.

1 A hearing on the Proposed Agreement was held on August 19-21, 24, 27-28, September 10-11, 14,  
2 14-18, 2009.

### 3 **III. LEGAL STANDARD FOR REVIEW AND APPROVAL.**

4 The Commission reviews the Proposed Settlement Agreement to determine whether it is in  
5 the public interest. And, since this involves a request by APS for a rate increase, the Commission  
6 reviews the rates produced by the proposed Agreement to determine whether they are just and  
7 reasonable.

8 Staff believes that the evidence in this matter supports adoption of the proposed Agreement as  
9 it is in the public interest and that the rates produced by the proposed Agreement are just and  
10 reasonable.

### 11 **IV. DISCUSSION.**

#### 12 **A. The Proposed Agreement In The Public Interest.**

##### 13 **1. The Agreement represents a compromise between very diverse interests 14 and was the product of vigorous negotiation.**

15 The Proposed Agreement was signed by 22 of the 24 parties to this Docket.<sup>1</sup> The signatories  
16 included parties with very diverse interests including the Staff, RUCO, the AZAg Group, the Arizona  
17 Association of School Business Officials, the Arizona Investment Council, the Arizona School  
18 Boards Association, Arizonans for Electric Choice and Competition, the Bowie Power Station, the  
19 Federal Executive Agencies, Freeport-McMoRan Copper & Gold, IBEW Locals 387, 640 and 769,  
20 Interwest Energy Alliance, Kroger Co., Mesquite Power, LLC, Southwest Energy Efficiency Project,  
21 Southwestern Power Group II, LLC, Town of Wickenburg and Western Resource Advocates. This  
22 list includes the state office that represents residential consumers and small business, an agricultural  
23 group, the schools' association, a group favoring competition in the electric industry, certain  
24 independent electric generators, the federal government including two of Arizona's largest military  
25 bases, Luke and Yuma Marine Air Station, union officials, industrial customers including Kroger,  
26 Catalyst Paper and SCA Tissue, and groups promoting energy efficiency and renewable energy, and a  
27 representative or advocate for low income customers. Only two parties to this case were not  
28 signatories to the Agreement, the Hopi Tribe and Mrs. Barbara Wyllie Pecora ("Pecora").

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<sup>1</sup> (Tr. at 46).

1 The Hopi Tribe has taken no position in the case or on the Proposed Agreement. Pecora's  
2 interest is very narrow in that it is limited to Schedule 3 and the Commission's readoption of the  
3 1,000 free footage allowance applicable to APS line extensions.

4 Perhaps the AIC attorney best summed up the nature of the negotiations in the following  
5 statement from his opening statement:

6 This agreement has brought together an incredibly diverse set of  
7 signatories who have concluded after many months of debate that it is  
8 in their individual, as well as in the public's best interest – intervenors  
9 ranging from school business officials and school boards through  
10 renewables and energy efficiency advocates, through large power users,  
low-income advocates, federal executive agencies, and the Residential  
Utility Consumer Office, through merchant power plant owners, to  
organized labor, and your Utilities Division Staff, they all recommend  
approval of the settlement agreement.<sup>2</sup>

11 All parties were invited to attend the Settlement meetings. APS filed notice of all of the  
12 meetings in the docket before they were held. Virtually all parties participated in every meeting with  
13 the exception of Pecora who attended the meeting specific to Schedule 3 free footage issues.

14 Freeport-McMoRan and AECC's attorney accurately described the settlement process in the  
15 following passages from his opening statement:

16 And the agreement was negotiated over a fairly long period of time.  
17 Basically, it involved three months almost daily meetings on many  
18 occasions, and many, many hours that were involved, not only in  
attending the meetings, but in preparing for those meetings. And as  
Mr. Mumaw also pointed out, a lot of those discussions were  
contentious. They were intense.<sup>3</sup>

19 The result of the negotiations and discussion was an integrated proposed agreement or a  
20 "package deal," because there was significant give and take by the various parties in connection with  
21 those negotiations.

22 **B. The Agreement Contains Important Provisions That Would Only Have Been**  
23 **Possible In Settlement.**

24 As several parties pointed out at the hearing, the Proposed Agreement is a package.<sup>4</sup> And,  
25 portions of the Proposed Agreement were the result of intense negotiation and unlikely to come out  
26 of a fully litigated hearing. The Signatories believe that the outcome produced by the Proposed  
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28 <sup>2</sup> *Id.* at 83.

<sup>3</sup> *Id.* at 91-92.

<sup>4</sup> *Id.* at 160.

1 Agreement is likely to be better than the outcome that would have been obtained through litigation.  
2 This was a theme in many of the Signatories' testimony in this proceeding. Counsel for the FEA  
3 stated in this regard:

4 And additionally, what I think is interesting that we haven't talked  
5 about much this afternoon in this context, and that is that there are some  
6 items in the settlement agreement that came up during the settlement  
7 agreement, and I don't know that they would have been something that  
8 would have been in an order had – if we go to a full hearing.

9 And in particular, the item that Mr. Crockett talked about on the self-  
10 direction for large customers, that was an item that came up during the  
11 negotiation and it is included in the settlement agreement, and we  
12 support that. Part of the reason that Federal Executive Agencies is  
13 interested in that is because we are a large customer, and we like the  
14 option of self-directing some of our demand-side management  
15 programs. So that's one example of the things that are included in the  
16 settlement agreement that I am not convinced would have come out in  
17 hearing or would have been part of a final order.<sup>5</sup>

18 Staff counsel reiterated this point in her opening statement:

19 We viewed this, frankly, as an opportunity to engage in problem  
20 solving in a way that a litigated case may well not have presented.  
21 Staff approached this case with the objective of finding ways to identify  
22 the causes underlying APS' perceived need to make repeated rate case  
23 filings and to find ways to begin to solve those issues.<sup>6</sup>

24 Staff counsel also stated:

25 There's the old cliché that two heads are better than one. I think in this  
26 case, 22 parties engaged in negotiations, with an opportunity for some  
27 creative problem solving, were able to produce an integrated agreement  
28 that in Staff's opinion is likely to be better than the outcome that we  
29 would obtain just through litigation.

30 The Agreement isn't perfect. No party got everything it wanted, Staff  
31 included. But Staff fully supports the proposed settlement agreement as  
32 filed, and we urge the Commission to approve it.<sup>7</sup>

33 RUCO's witness Johnson reiterated this theme as well:

34 And I think there was a lot of discussion that very successfully brought  
35 forth what the core issues were and what could be done about it. And  
36 an attempt was made to share the burden of solving the problem and not  
37 entirely putting it on customers and not simply through rate relief, but  
38 also through appropriate refocusing on management's attention to  
39 certain benchmarks and a commitment to provide more equity and to  
40 strengthen the balance sheet, that ultimately we think this of greater

41 <sup>5</sup> *Id.* at 169-70.

42 <sup>6</sup> *Id.* at 198.

43 <sup>7</sup> *Id.* at 200-01.

benefit to consumers than the 8 percent increase in nonfuel rates, the net of which may actually turn out to be somewhere in the order of 1 percent.<sup>8</sup>

**C. The Agreement Contains A Comprehensive Plan Which Is Geared To Put The Company Back On The Path To Financial Stability.**

An issue of fundamental importance to all of the signatories was the ability to come up with a plan to put the Company back on the path to financial stability and to break the repeated cycle of rate case filings based upon an FFO-to-Debt ratio that was hovering above junk status.

As one of the Signatories stated:

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.<sup>9</sup>

**1. The rate increase provided for in the Proposed Settlement Agreement is just and reasonable.**

The Parties agreed first that the interim increase of \$65.4 million should be confirmed without any refund obligation.<sup>10</sup> The Agreement also provides that APS will receive an additional non-fuel Base Rate Increase of approximately \$131.1 million.<sup>11</sup> Together, the interim increase and the additional non-fuel Base Rate Increase result in an overall non-fuel Base Rate Increase of \$196.3 million.<sup>12</sup> In addition, the Agreement allows APS to recover an increase in base fuel costs of \$137.2 million, and a fuel-related increase in base rates of \$11.2 million, for a total base rate increase of \$344.7 million.<sup>13</sup>

In terms of the revenue requirement, in the Proposed Agreement, the Agreement provides for a total base rate revenue requirement of \$2,982,185,000.<sup>14</sup> Comparing this with the total base rate revenue requirement approved in APS' last case (Decision No. 69663) issued on June 28, 2007, the authorized base rate revenue requirement was \$2,931,653,000.<sup>15</sup> That was a percentage increase of

<sup>8</sup> *Id.* at 1920.

<sup>9</sup> *Id.* at 1932.

<sup>10</sup> Proposed SA at 12, ¶ 3.1.

<sup>11</sup> *Id.* at ¶ 3.2.

<sup>12</sup> *Id.* at ¶ 3.3.

<sup>13</sup> *Id.* at ¶ 3.6.

<sup>14</sup> (Tr. at 1687).

<sup>15</sup> *Id.* at 1686.

1 12.33 percent.<sup>16</sup> There is a net difference between the two revenue requirements of \$50,532,000 or  
2 approximately a 1.7 percent increase.<sup>17</sup>

3 The rate increase contained in the Settlement Agreement is higher than the amount  
4 recommended by Staff, about the same as that recommended by AECC and is more than \$100 million  
5 lower than the amount requested by APS. While it did not recommend a reduction in APS' rates,  
6 RUCO originally determined that a \$13.4 million revenue decrease was appropriate.<sup>18</sup> In his opening  
7 statement, RUCO's counsel addressed the \$196.3 million in additional base rate revenues called for  
8 by the Agreement:

9 You see, we believe it is no longer in ratepayers' or even the state's  
10 best interest to find a short-term solution which will allow the company  
11 to operate on the margin until the next opportunity for it to file a rate  
12 case, which, we all know, would be as soon as possible. No, we believe  
13 that the better approach is a comprehensive, long-term plan which will  
14 require the efforts of not only the ratepayers, but the company's  
15 shareholders and the company's management.

16 The objective, from our viewpoint, is to place the company in a better  
17 financial position so, among other things, it can continue to provide  
18 quality service at a reasonable price, meet energy efficiency goals and  
19 expand its renewable energy commitment.<sup>19</sup>

20 There was much concern expressed at the hearing regarding the uncertain financial times and  
21 the ability of the public to absorb the rate increase at this time. A bill impact statement was filed  
22 jointly by the parties on May 15, 2009. At that time, there was less certainty about the impact of the  
23 adjustors, specifically the energy efficiency adjustor mechanism and the RES adjustor.<sup>20</sup> Subsequent  
24 to that filing, first on July 1st with regard to RES, and then on July 15<sup>th</sup> with regard to energy  
25 efficiency, actual implementation plans were submitted to the Commission with more or less hard  
26 dollar figures, and therefore, hard impacts on those two particular adjustors, and that slightly changed  
27 the bill impact analysis.<sup>21</sup> A revised bill impact analysis was filed with the Supplemental Testimony  
28 of David Rumolo on July 17, 2009, which reflected these later RES and energy efficiency filings.<sup>22</sup>

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26 <sup>16</sup> *Id.*

27 <sup>17</sup> *Id.* at 1687.

28 <sup>18</sup> *Id.* at 171.

<sup>19</sup> *Id.* at 172.

<sup>20</sup> *Id.* at 191.

<sup>21</sup> *Id.* at 192.

<sup>22</sup> *Id.* at 193.

1 There is a base rate impact average of \$6.38 per month and that has been revised to \$6.24 per month  
2 on an average kilowatt usage basis.<sup>23</sup>

3 Of further significance, is the fact that APS is projecting that the ultimate impact of the  
4 Agreement upon consumers will be approximately 1 percent over current levels of rates, taking into  
5 account the interim increase and the PSA adjustor.<sup>24</sup> If the Proposed Agreement is approved, base  
6 rates (including the amount already approved as an interim increase) would increase by about 13  
7 percent. However at the same time the PSA will fall to zero. And, the interim adjustment surcharge  
8 is going to go to zero. Finally, the lower fuel costs will be reflected in the PSA in early 2010. The  
9 result should be on average a net increase of about 1 percent, according to APS.<sup>25</sup>

10 Concern was also expressed at the hearing that APS is getting a lot more fuel costs in base  
11 rates at the same time that the price of natural gas on the wholesale market is declining.<sup>26</sup> Fuel costs  
12 in the Proposed Agreement were aligned with APS' then most recent PSA filing with respect to its  
13 projected fuel costs.<sup>27</sup> And, the reductions in natural gas prices will be passed through to customers.  
14 The lower fuel costs will be reflected in customer bills through a negative PSA rate on customers'  
15 bills in 2010.<sup>28</sup> Further, the Proposed Agreement provides that the PSA adjustor, if it shows a  
16 credit, will be accelerated so that it will line up with implementation of the rate increase.<sup>29</sup> While a  
17 portion of fuel costs will be rolled into base rates, the PSA will measure the fuel costs that are in base  
18 rates and take the difference between that and actual costs, or projected costs with a historical true-  
19 up, and either charge customers or pay customers a credit after the 90/10 sharing.<sup>30</sup>

20 **2. Several provisions of the Proposed Agreement were also designed to**  
21 **provide the Company with enhanced earnings to improve its financial**  
22 **position during the rate case filing plan period.**

23 The Signatories also agreed to three provisions (Sections IX, X and XI), which allow for  
24 enhanced earnings by the Company. These provisions were intensely negotiated and the Proposed  
25 Agreement probably would not have been possible without them.

26 <sup>23</sup> *Id.*

27 <sup>24</sup> *Id.* at 329.

28 <sup>25</sup> *Id.*

29 <sup>26</sup> *Id.* at 302.

30 <sup>27</sup> *Id.* at 303.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 304-05.

1 Section IX of the Agreement entitled Pension and OPEB Deferrals. The Agreement allows  
2 APS to defer for future recovery, a portion of its annual Pension and OPEB costs above or below the  
3 test year level in years 2011 and 2012, subject to the following maximum amounts:

- 4 a. 2011: deferral cannot exceed the lower of \$13.5 million or 50% of the  
5 cost above the test year level;  
6 b. 2012: deferral cannot exceed \$29 million of the cost above the test  
7 year level.

8 The test year level of Pension and OPEB expense is \$23.949 million on a total Company  
9 basis.

10 Section X of the Proposed Agreement allows APS to temporarily record proceeds from its  
11 line extension policy ("Schedule 3") as revenue during the period from January 1, 2010 through  
12 either the earlier of December 31, 2012, or the conclusion of the Company's next general rate case.  
13 Thereafter, Schedule 3 receipts would be again recorded as CIAC, unless otherwise ordered by the  
14 Commission. The income resulting from the revenue treatment to Schedule 3 is estimated by APS to  
15 be \$23 million in 2010, \$25 million in 2011 and \$49 million in 2012.

16 Section XI of the Proposed Agreement provides for an adjustment of depreciation rates in  
17 connection with a Palo Verde License extension. APS is authorized to adjust depreciation rates used  
18 for recording depreciation expense on the Palo Verde generating unit to reflect the license extension  
19 upon the later date of (1) receiving Nuclear Regulatory Commission approval for the license  
20 extension or (2) January 1, 2012. APS estimates that the change in depreciation rates due to the  
21 approved license extension will result in a reduction to APS' depreciation expense in the approximate  
22 amount of \$34 million annually on an ACC jurisdiction basis. The reduced depreciation expense  
23 would be recognized as an expense reduction in the context of the reestablishment of new base rates  
24 in APS' next base rate case.

25 **3. An 11% ROE is warranted in this case.**

26 Section IV of the Proposed Agreement provides for a return on common equity of 11.0%.  
27 This is less than the return on equity requested by APS. Staff's witness David Parcell, a well-  
28 recognized expert witness on cost of capital, included 11 percent within his upper end of  
reasonableness for APS. He also stated that when you take into account that the 11 percent is

1 calculated looking at what is primarily a historic test period, the circumstances this company faces  
2 and given the steady increase in its infrastructure, that 11 percent is reasonable in this particular case.

3 <sup>31</sup> AECC witness Higgins also stated that it was unlikely that APS would in fact earn 11% on its  
4 equity in 2010 or 2011.

5 While the 11% is somewhat on the upper range of utility authorized returns, it is reasonable in  
6 this case.<sup>32</sup> According to one witness, returns more in the range of 10.75 and 10.50 have been most  
7 recently established in cases in jurisdictions which utilize a projected test year.<sup>33</sup>

8 Commissioner Pierce astutely observed that, if the return on FVRB were converted into a  
9 return on OCRB, this would be the equivalent of an ROE on OCRB of approximately 12 percent, and  
10 it was suggested that adjusting downward the FVRB and adjusting upward the ROE stated to apply to  
11 OCRB would improve the “optics” of the decision to investors and Wall Street, without changing the  
12 amount of revenue increase.<sup>34</sup> Staff has no objection to mentioning the results of such calculations in  
13 the Commission’s order on this matter, and agrees that highlighting the OCRB equivalent ROE of  
14 Arizona’s unique aspect of Fair Value based utility regulation might help improve Wall Street and  
15 investor perceptions. In view of the need to meet the Arizona Constitutional requirement to consider  
16 Fair Value, which has been emphasized by a recent Arizona Court of Appeals decision, Staff would  
17 caution against amending the Settlement Agreement to change the FVRB amount provided for in the  
18 Agreement, which is supported by the evidence in the record of the case.<sup>35</sup> In addition, the fair value  
19 determination needs to be a part of the Commission’s Order as well.

20 **4. The Settlement Agreement incorporates a rate stability plan.**

21 The Proposed Agreement also incorporates what is called a Rate Stability Plan. That  
22 provision is contained in Section II of the Agreement.

23 As was testified to by Mr. Abinah, from Staff’s perspective an important aspect of the  
24 Settlement is specifically that it breaks the recent cycle of nearly annual APS applications for some  
25 form of rate relief.

26  
27 <sup>31</sup> *Id.* at 343.

<sup>32</sup> *Id.* at 327.

28 <sup>33</sup> *Id.* at 328.

<sup>34</sup> Tr. at 1733-1735. Depending upon rounding, the calculation is in the range of 12.02 to 12.06 percent.

<sup>35</sup> Tr. at 1733-1735.

1 [F]rom experience they have been here year after year after year. So  
 2 there is a tendency that they would turn around and file another rate  
 3 case. But with this stay-out provision, we know that the ratepayers will  
 4 not see a rate increase at least for two years, if not longer. But like I  
 said, based on experience, I believe in the past five years, they have  
 been here about four or five times. But with this provision we know  
 that the ratepayers would not see a rate increase for at least two years.<sup>36</sup>

5 Consequently, the Settlement also provides rate stability to ratepayers.<sup>37</sup>

6 As discussed earlier, the Proposed Agreement benefits ratepayers by placing APS on a  
 7 general rate case filing schedule.<sup>38</sup> Pursuant to the terms of the Proposed Agreement, APS can only  
 8 request base rate increases over the term of the Settlement in two planned applications on June 1,  
 9 2011 and June 1, 2013, respectively.<sup>39</sup> The benefit to this provision is that it will provide stability in  
 10 rates over the term of the Agreement.<sup>40</sup> As Mr. Abinah explained, ratepayers have experienced  
 11 frequent rate increases over the preceding five years and this provision breaks the cycle to provide  
 12 APS ratepayers with relief from rate increases for a set period. "But right now we believe the benefit  
 13 is for APS to stay out for two years, because that is a rate increase that ratepayers will not  
 14 experience."<sup>41</sup>

15 Some concern was expressed at the hearing that the stay-out provision was too short  
 16 and was in essence meaningless. But it is actually very meaningful from the perspective that APS  
 17 has filed five rate cases in the last six years (including interim cases).<sup>42</sup> Continuing the stay out  
 18 beyond the two years in the Agreement could produce a very negative reaction on Wall Street.<sup>43</sup>  
 19 Further, typically the longer the stay-out, the larger the premium the utility is going to require in the  
 20 negotiation to incur the risk of that stay-out.<sup>44</sup> The stay-out provision in the Settlement Agreement  
 21 achieved the best balancing point between those tensions.<sup>45</sup>

22  
 23  
 24  
 25 <sup>36</sup> Tr. (Vol. VIII) at 1820:17-1821:2

26 <sup>37</sup> Tr. at 1802.

27 <sup>38</sup> Proposed SA at 10, ¶ 2.1.

28 <sup>39</sup> *Id.*

<sup>40</sup> Tr. at 1820.

<sup>41</sup> *Id.* at 1823.

<sup>42</sup> Tr. at 305.

<sup>43</sup> Tr. at 1988-99.

<sup>44</sup> *Id.* at 306-07.

<sup>45</sup> *Id.* at 307.

1                   **5. Equity infusions and related imputed debt commitment and APS Plan to**  
2                   **improve its financial condition.**

3                   Another very crucial component of the financial provisions of the Proposed Agreement is  
4                   Section VIII, which requires APS to complete at least \$700 million in equity infusions during the  
5                   period beginning June 1, 2009 through December 31, 2014. This provision, along with other related  
6                   provisions, is designed to address the core problem in recent years the weakness in the Company's  
7                   FFO to debt ratio.<sup>46</sup>

8                   Most of APS' recent cases for rate relief have been predicated upon an eminent downgrade to  
9                   junk bond status. APS is now at a BBB minus rating (according to Standard and Poors, one of the  
10                  major bond rating agencies) which is the lowest rating given to investment-grade bonds, or  
11                  investment-grade debt.<sup>47</sup> If APS were to have its debt downgraded by S&P below BBB minus, then  
12                  its considered noninvestment grade or otherwise known as junk bonds. If that threshold is crossed,  
13                  then the cost of borrowing can be significantly higher.<sup>48</sup>

14                  An equity infusion would improve the FFO-to-debt ratio because it would either substitute for  
15                  debt, or in some instances actually retire debt.<sup>49</sup> While an equity infusion is not a substitute for an  
16                  adequate level of funds from operations, trying to solve the FFO-to-debt ratio purely through raising  
17                  rates is not optimal either.<sup>50</sup>

18                  Concern was expressed at the hearing that the Proposed Agreement left too much discretion  
19                  with APS as to when it could make the equity infusions and that the Company could technically wait  
20                  until the end of the Agreement's term before making any infusions. However, all of the testimony at  
21                  the hearing, including APS' own testimony, suggests that the provisions of the Proposed Agreement  
22                  will require the Company to make equity infusions well before the end of the Plan. Most signatories  
23                  also agreed that the timing as to when to go to market for equity or additional equity should be left  
24                  with utility management to find the optimal time to do so.<sup>51</sup> The utility has a strong interest in

25                  <sup>46</sup> *Id.* at 1928.

26                  <sup>47</sup> *Id.* at 315.

27                  <sup>48</sup> *Id.* The interest rate spread between S&P investment grade bonds and S&P speculative grade bonds skyrocketed to  
28                  an historical high after the worldwide credit crisis stemming from events such as the collapse of Lehman Brothers in  
29                  September 2008. It has moderated somewhat since, but remains at a level of several hundred basis points. Such  
30                  developments have highlighted the need to protect ratepayers from significantly higher APS borrowing costs, and the  
31                  need to preserve APS' ability to borrow on reasonable terms.

32                  <sup>49</sup> *Id.* at 1950.

33                  <sup>50</sup> *Id.*

34                  <sup>51</sup> *Id.* at 309.

1 retaining solid financial metrics and getting the best value it can get when it goes to the market. In  
2 particular, in light of the unstable capital markets in recent times, the timing should remain with the  
3 utility subject to some basic parameters.<sup>52</sup> The Proposed Agreement sets those parameters. For  
4 instance, APS has committed to achieving a proportion of debt-to-total capitalization of 52%.

5 The Proposed Agreement also recognizes that if a company actually has more equity, the  
6 revenue requirement may become higher. In other words, a company that has a greater proportion of  
7 equity can produce a higher overall weighted average cost of capital because equity is more  
8 expensive than debt.<sup>53</sup> Thus, a larger amount of equity may actually turn into an argument by the  
9 utility for a larger rate increase to pay the return on the equity.<sup>54</sup> From a customer interest  
10 perspective, the optimal condition that should result in the lowest reasonable cost of capital results  
11 when the utility maintains enough equity so that it's financially stable and can avoid having to file  
12 emergency rate increases, but not so much equity that it becomes a costly burden with respect to the  
13 return to which the utility is entitled.<sup>55</sup> Section VIII of the Proposed Agreement recognizes this by  
14 requiring APS to use its best efforts to maintain a balance capital structure that optimizes benefits to  
15 ratepayers.

16 Further, when the parties looked at APS' FFO-to-Debt ratio, it was recognized that a  
17 contributing factor was the number of purchased power contracts, which were resulting in an imputed  
18 debt level around 57 percent.<sup>56</sup> Fifty-seven percent in imputed debt is very close to the high end of  
19 the aggressive category, and well in excess of the intermediate category.<sup>57</sup>

20 Thus, another provision in Section VIII commits the Company to use its best efforts to  
21 improve its financial metrics and bond ratings, by completing timely equity infusions and taking  
22 other measures to strive to achieve a capital structure with no more than 52% debt/total capital, as  
23 calculated by the credit rating agencies, by December 31, 2012.

24 The Proposed Agreement's requirements with respect to imputed debt are significant. To go  
25 from 57 to 52 percent is the equivalent of at least 700 or 800 million dollars worth of equity.<sup>58</sup> (This

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26 <sup>52</sup> *Id.*

27 <sup>53</sup> *Id.* at 317.

28 <sup>54</sup> *Id.*

<sup>55</sup> *Id.* at 318.

<sup>56</sup> *Id.* at 1951.

<sup>57</sup> *Id.*

<sup>58</sup> *Id.* at 2046.

1 is to be distinguished from the parties proposed capital structure with 46.21 percent debt for  
2 ratemaking purposes. For purposes of the FFO to Debt ratio, the rating agencies calculation is  
3 different and is now 11 percent higher because S&P includes purchased power contracts and the Palo  
4 Verde leaseback and other items like that).<sup>59</sup>

5 A related and extremely important provision in the Proposed Agreement requires APS to  
6 prepare and submit to the Commission and Signatories within 120 days of approval of the  
7 Agreement, a plan detailing steps it intends to take to maintain and improve its financial ratings with  
8 the credit rating agencies. Such a plan is very important because it finally will allow the Commission  
9 to drill down and evaluate the specifics underlying the problem relating to APS' FFO-to-Debt ratio  
10 that APS has cited as a primary area of concern with the bond rating agencies in hearings before the  
11 Commission over the past few years. For instance, as discussed earlier it was suggested at hearing  
12 that APS' imputed debt ratio is so high because of its purchased power contracts. At hearing it was  
13 brought out that the type of purchased power contract can dramatically affect the treatment it receives  
14 from the credit rating agency. A short-term arrangement in which APS has the option of buying the  
15 power has a smaller impact on the imputed debt component.<sup>60</sup> If it's a 30-day obligation, the rating  
16 agencies probably won't even include it. If it's an obligation of a year or two, the agency will include  
17 it to an extent. Five years is significant enough that the agency would do a calculation and it would  
18 contribute to the 57 percent, but to a lot less extent than if it was a 20 year obligation.<sup>61</sup> Thus, the  
19 manner of determining the debt to be imputed and the calculation of it will be substantially  
20 influenced by the specifics of the contract in question.<sup>62</sup> The Plan puts an express obligation on the  
21 Company to demonstrate in a concrete manner how it intends to improve its financial ratings through  
22 additional equity, cost saving measures, and imputed debt reductions.

23 From a regulatory perspective, part of the problem with the imputed debt levels and the  
24 Company's FFO-to-Debt ratio is that the agencies are looking at "imputed debt", something that the  
25 Commission doesn't normally look at. The Commission looks at the funding of the rate base as  
26 opposed to the funding that the rating agencies are focused upon, which includes imputed debt for

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27 <sup>59</sup> *Id.* at 2043.

28 <sup>60</sup> *Id.*

<sup>61</sup> *Id.* at 2056.

<sup>62</sup> *Id.*

1 power purchase agreements and other items of significance.<sup>63</sup> The plan required in the Agreement  
2 will force APS to address the causes of its current situation and come up with additional workable  
3 solutions, beyond those already provided for in the proposed Agreement.

4 As part of its Plan, the Company committed to including a discussion of its imputed debt  
5 obligations which the Commission can review to hopefully obtain some insight into the Company's  
6 situation.<sup>64</sup>

#### 7 **6. The Agreement Addresses the Impacts of Regulatory Lag.**

8 The \$196.3 million Base Rate Increase includes, in addition to other items contained in Staff's  
9 direct case, inclusion of post-test year plant through June 30, 2009, or eighteen months beyond the  
10 test year ending December 31, 2007.<sup>65</sup>

11 According to the Company, it will need 6500 megawatts of new resources by 2025 to serve a  
12 customer count which is going to grow by 600,000 at a total cost of \$15 billion.<sup>66</sup>

13 For regulatory purposes, the Commission uses what is known as a historic test period. This  
14 measures the utility's return on the assets that it had in a prior year, even though the assets that it has  
15 in place are different than that today. APS has made more investment since the time of the test  
16 period.<sup>67</sup> In order to address the issue of regulatory lag and the impact of such lag on APS' ability to  
17 maintain and improve its financial position, the Proposed Agreement recognizes assets that were  
18 acquired and devoted to service after the test period.

19 Regulatory lag is oftentimes viewed as being in the interest of ratepayers because it creates an  
20 incentive for companies to manage efficiently. The utility management's willingness to keep  
21 incurring costs is held in check by the knowledge that there is a period between rate cases during  
22 which the utility is responsible for changes in its cost of service and revenue requirement before such  
23 changes are reflected in new rates. However, an excessive regulatory lag is not in the consumer's or  
24 utility's interest. Because of the significant investment levels made by the Company and in the  
25

26  
27 <sup>63</sup> *Id.* at 1952.

<sup>64</sup> *Id.* at 2484-85.

28 <sup>65</sup> (Proposed SA at 12, ¶ 3.4.).

<sup>66</sup> (Tr. at 86).

<sup>67</sup> *Id.* at 327.

1 interest in addressing some of the Company's underlying problems, Staff believed it was important to  
2 address the issue of regulatory lag in part in the Proposed Agreement.

3 Some concern was raised at the hearing that the Proposed Agreement does not include an  
4 offset in recognition of 2009 sales levels since June 2009 plant levels are being used.<sup>68</sup> Reference  
5 was to Mr. Higgins direct testimony:<sup>69</sup>

6 If rates are set to recover costs associated with 2009 rate base, it is  
7 essential that cost recovery be spread across the projected 2009 sales  
8 that will be served by this rate base. It would not be reasonable to pay  
9 for 2009 rate base using end-of-year 2007 sales levels.<sup>70</sup>

10 AECC witness Higgins explained that while there was not an offset included for 2009 sales,  
11 there was a mitigating circumstance that produced an acceptable result:

12 The settlement agreement does not include a kind of offset that I said  
13 should occur in the lines that you asked me to read into the record. ...  
14 It is not based on 2009 sales level; however, there is a mitigating  
15 circumstance, and that is that with the aggressive DSM or energy-  
16 efficiency projections or requirements that are part of this agreement, I  
17 can tell you that APS would prefer to have the sales reductions from  
18 that projected energy efficiency built into the billing determinates in  
19 setting these rates, and that has not occurred either.

20 And so while the kind of adjustment that I was proposing in my direct  
21 testimony with respect to 2009 project sales, while that is not  
22 incorporated within the agreement nor is there a recognition of  
23 diminished kilowatt-hour sales as a result of energy efficiency. So in  
24 my view, the combination of those two things has produced a result that  
25 is acceptable.<sup>71</sup>

26 In summary, the Agreement strikes an appropriate balance in addressing APS' concerns about  
27 regulatory lag and the concerns of other parties about maintaining the integrity of the regulatory  
28 framework.

29 **7. The Agreement provides for expense reductions by the Company of at  
30 least \$30 million per year over the life of the plan.**

31 Section VII of the Proposed Agreement provides for APS to reduce its expenses by an  
32 average of \$30 million per year beginning in the year 2010. The \$30 million average annual expense  
33 reduction by APS is to continue through the Plan Term so that the total expense reduction by APS for  
34 the Plan Term shall be at least \$150 million.

35 \_\_\_\_\_  
36 <sup>68</sup> *Id.* at 337-38.

37 <sup>69</sup> (Ex. AECC-3 at 20).

38 <sup>70</sup> *Id.* at 337.

39 <sup>71</sup> *Id.* at 338-39.

1 In addition to granting an interim rate increase, Decision No. 70667 (December 24, 2008)  
 2 obligated APS to reduce its operational expenses by \$20 million or 2.6 percent below its 2007 test  
 3 year operations and maintenance expense in 2009.<sup>72</sup> The Proposed Agreement obligates APS to  
 4 substantially exceed those previously identified annual levels of expense reduction. APS will  
 5 increase the reduction to an average \$30 million per year reduction beginning in 2010 through  
 6 December 31, 2014.<sup>73</sup> As explained by APS witness Jeff Guldner,

7 [Y]ou will have cost reductions that average 30 million a year which  
 8 would result in 150 million. In some years it may be less. In some  
 9 years it may be more. But there is the \$25 million threshold. So what  
 10 that's removing is every year out of the cost structure, when you go in  
 11 for that rate case, the 2010 rate case, there will be \$30 million removed  
 12 from the cost structure.<sup>74</sup>

11 While APS has some discretion to determine from what areas to make the reductions, the  
 12 reductions may not be made to any costs necessary to maintain safe and reliable service.<sup>75</sup>

13 The expense reductions are not limited to operational expenses.<sup>76</sup> There was some concern  
 14 expressed at the hearing that perhaps the reductions made by the Company should all come out of  
 15 operational expenses.<sup>77</sup> One of the signatories accurately responded that the parties anticipated that  
 16 the expenses that would be subject to this provision would be included in the ratemaking formula, but  
 17 felt that there was no need to limit the Company's discretion in advance.<sup>78</sup>

18 There was also a concern at the hearing that the depreciation expense reduction associated  
 19 with the Palo Verde License Extension might be included as part of the \$30 million expense  
 20 reduction thus significantly diluting its significance or impact. However, inclusion of this  
 21 depreciation expense reduction in the \$30 million commitment was not contemplated by any of the  
 22 parties and may not be used by APS to meet the \$30 million commitment in paragraph 7.1.<sup>79</sup>

23  
 24  
 25  
 26 <sup>72</sup> Dec. No. 70667 at 44.

<sup>73</sup> (Proposed SA at 15, ¶ 7.1).

<sup>74</sup> (Tr. at 1199-1200).

<sup>75</sup> (Proposed SA at 16, ¶ 7.4).

<sup>76</sup> *Id.* at 2036.

<sup>77</sup> *Id.* at 2037.

<sup>78</sup> *Id.* at 2038.

<sup>79</sup> *Id.* at 301.

1                   **D.     The Agreement's Provisions On Schedule 3 Are Reasonable.**

2                   **1.     The Commission should not reinstate the previous line extension**  
 3                   **policy that allowed free footage.**

4                   The lone party in opposition to the Proposed Agreement is Intervenor Pecora, an experienced  
 5 Arizona realtor who has concerns about the statewide effects of APS' current line extension tariff.<sup>80</sup>  
 6 Pecora urges the Commission to reinstate APS' previous line extension tariff, which allowed  
 7 homebuilders one thousand (1,000) free feet toward a line extension in certain circumstances.<sup>81</sup>  
 8 Pecora alleges that APS' current line extension tariff is substantially limiting Arizona's economic  
 9 growth and that reinstatement of the previous tariff is necessary in order to address Arizona's  
 10 economic downturn.<sup>82</sup> Staff contends that Pecora's allegations are exaggerated and are not supported  
 11 by the record.

12                  As part of her case, Pecora commissioned a study by Elliott Pollack & Company, a (describe  
 13 the firm), to analyze the effects of APS' current line extension tariff. Although the study was  
 14 conducted by a professional consultant, it is only a "limited impact analysis," and it does not purport  
 15 to evaluate whether the change in line extension policy has *actually resulted* in fewer homes being  
 16 built.<sup>83</sup> Instead, the study focuses on quantifying the economic impacts (in terms of job loss,  
 17 diminished economic activity, and unrealized government revenues) of the failure to construct one  
 18 hundred (100) homes.<sup>84</sup> This exercise, however, does not provide support for Pecora's claims.

19                  Rick Merritt, the witness who presented the study, candidly acknowledged that "it is not  
 20 known how many homes may not be built due to the increased cost" of line extensions, and even  
 21 acknowledged that he does not have evidence that even ten (10) homes will not be built as a result of  
 22 the changes to Schedule 3.<sup>85</sup> Mr. Merritt's testimony merely *assumes* the point that Pecora seeks to  
 23 establish, *i.e.*, that the APS line extension tariff has negatively impacted Arizona's economy, and then  
 24 seeks to quantify those assumed results.

25  
 26  
 27 <sup>80</sup> (Tr. at 444).

<sup>81</sup> *Id.* at 442-43.

<sup>82</sup> *Id.* at 76-77, 361-62, 386-87, 1863-64.

<sup>83</sup> (Tr. at 380-82, 388-89, *see also* Ex. APS-16 at 5-6).

<sup>84</sup> Tr. at 386.

<sup>85</sup> *Id.*

1 As Mr. Merritt acknowledged, the study does not establish that the line extension policy is the  
2 cause of the economic downturn, and it does not establish that the changes to Schedule 3 have had  
3 any impact on the value of land.<sup>86</sup> The Elliott Pollack study simply does not support Pecora's  
4 allegations that the changes to Schedule 3 have undermined Arizona's overall economy, eliminated  
5 jobs, prevented economic development, and contributed to declines in government tax revenues.<sup>87</sup>  
6 The evidence otherwise introduced by Pecora is, for the most part, merely anecdotal.<sup>88</sup> Taken as a  
7 whole, Pecora's evidence does not support her factual allegations.

8 The issue of whether to provide a free footage allowance is a policy question for the  
9 Commission, and there are certainly policy arguments that can be advanced on either side of the  
10 issue. All parties to this case understand and agree that installing a line extension is in fact not "free."  
11 There is a cost entailed in doing this, and the cost can be significant. The issue, then, is who should  
12 pay for such cost? Should it be the specific entity that wants the line extended, or should it be the  
13 general body of the utility's existing ratepayers, who end up paying for plant that is included in the  
14 utility's rate base. The "who pays" question also involves consideration of who is the cost causer and  
15 whether there is some social or regulatory policy reason for having a subsidy.

16 In recent years, the Commission has elected to eliminate free footage provisions in various  
17 electric utilities' main extension tariffs in an effort to more closely assign the costs of growth to the  
18 cost causers, *i.e.*, those responsible for the growth. The Commission has eliminated free footage  
19 allowances not only for APS, but also for Tucson Electric Power Company, Unisource Electric,  
20 TRICO, Sulphur Springs Valley, and Graham County Electric. By incorporating APS' current main  
21 extension tariff into the proposed Agreement, the Parties are not suggesting a departure from  
22 established Commission policy, but are instead submitting a settlement proposal that is entirely  
23 consistent with APS' existing line extension tariff and with the Commission's existing policies.

24 Fundamental to ratemaking is the principle that "costs should be assigned to the cost causer to  
25 the greatest extent practical."<sup>89</sup> APS' existing line extension policy is consistent with this general  
26 principle. As noted by AECC witness Higgins,

27 \_\_\_\_\_  
<sup>86</sup> *Id.* at 389.

28 <sup>87</sup> (*See Tr.* at 388).

<sup>88</sup> (*Id.* at 360-65).

<sup>89</sup> *Id.* at 241.

1 [I]f the true costs of extending power lines is not included in the  
2 decisions made by individuals purchasing land and building homes but  
3 instead is socialized to other parties, then it can result in a more  
4 expensive option being selected than would otherwise occur. . . .  
[I]t's not sound public policy to mask these costs so that they are not  
taken into account in private decision making.<sup>90</sup>

5 Free footage not only would mask the true costs of an extension so that more expensive options  
6 would be selected, but also would spread the costs of these more expensive options to the general  
7 body of ratepayers, thereby resulting in higher rates.<sup>91</sup> In a high-growth state, such as Arizona, these  
8 results could be even more pronounced.<sup>92</sup> Mr. Merritt, the primary author of the Elliott Pollack  
9 study, does not appear to disagree with these principles.<sup>93</sup>

10 In this case, Pecora is asking the Commission to immediately reinstate the previous line  
11 extension policy, in which customers in some circumstances received a free footage allowance of one  
12 thousand (1,000) feet. Evidence submitted in the record concerning what other states and other  
13 utilities allow for line extensions indicates that an allowance of 1,000 feet up to \$25,000 was very  
14 unusual and represented a much larger "free" allowance than just about anywhere else. (See Survey  
15 that was attached to Staff Witness Abinah's Testimony). Instead of reinstating the former policy, the  
16 Commission could also consider a compromise approach.<sup>94</sup> In other words, the Commission could  
17 adopt an approach that would provide something less than 1,000 feet free, or that allows a specific  
18 dollar amount as an allowance. Exhibit S-17 contains a table illustrating the costs associated with  
19 various amounts of free footage and/or free allowance.

20 Staff, however, supports the Agreement as proposed. And Staff would caution that changing  
21 APS' line extension tariff in this case, even in a nominal way, may undermine the Proposed  
22 Agreement, the provisions of which are delicately balanced. Staff's position is that \$344 million, the  
23 amount of the base rate increase ultimately proposed by the Agreement, is the most that Staff would  
24 recommend in terms of a base rate increase. On the other hand, it is Staff's impression that APS is  
25 unlikely to accept that amount of base rate increase (\$344 million) without some sort of mechanism

26 \_\_\_\_\_  
27 <sup>90</sup> *Id.* at 241-42; *see also* Tr. at 252-53.

<sup>91</sup> (Tr. at 254-56).

<sup>92</sup> *Id.* at 257.

<sup>93</sup> *Id.* at 390 (acknowledging that removal of free footage leads to base rates that are lower than they might otherwise  
be).

<sup>94</sup> *Id.* at 377.

1 to enhance revenues in the outlying years of the stay-out period. The Schedule 3 treatment, which  
 2 provides that Schedule 3 receipts will be treated as revenue, is the means that the Proposed  
 3 Agreement uses to accommodate these dual concerns.

4 A change to the Schedule 3 tariff, such as Pecora recommends or even something more  
 5 moderate, hits at a significant point of tension, *i.e.*, the mechanism that allows the base rate increase  
 6 to be held at \$344 million, but at the same time allows APS' revenues to be enhanced in the outlying  
 7 years through an accounting provision. From Staff's perspective, this provision can be viewed as  
 8 among the provisions that made the settlement possible. It is important to recognize that changing  
 9 Schedule 3 to provide for some level of "free footage" allowance is likely to have significant  
 10 ratemaking consequences, either to ratepayers if there were to be a corresponding revenue increase or  
 11 to APS if there were none.

12 Moreover, one of the fundamental objectives of the Signatories was to obtain an improvement  
 13 in the Company's financial condition, bond rating and to proactively address concerns that have been  
 14 cited by APS for its present bond rating including concerns related to the FFO-to-Debt ratio. The  
 15 impact of the elimination of free footage on the Company's FFO-to-Debt ratio was specifically  
 16 addressed in the following exchange:

17 **Q. (Commissioner Mayes)** You believe that APS's FFO-to-debt ratio or -- well,  
 18 do you believe that APS's FFO-to-debt ratio would be at 18 percent, which I  
 19 think is roughly where it is or is sort of, you know, hovering around junk bond  
 status, or their credit rating would be a BBB minus if the Commission had  
 eliminated the free-line extension policy 10 years ago rather than 2 years ago?

20 **A. (Mr. Higgins)** That is a great question. I have not gone back and tried to  
 21 answer that, but I do think that had that action been taken ten years ago, it  
 22 certainly would have alleviated a fair amount of pressure on APS's bond  
 rating.<sup>95</sup>

23 Staff recognizes that this issue is entirely a matter of policy and that the Commission may  
 24 elect to forego the strict regulatory principle of assigning costs to the cost causer in favor of a more  
 25 socialized approach that spreads costs over a broader base. This latter approach was the basis of  
 26 APS' previous version of Schedule 3.

27  
 28  


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<sup>95</sup> *Id.* at 256.

1 Reverting back to the 1,000 free footage allowance in the context of this proceeding may  
2 result in putting more pressure on APS' bond rating, and thus counteracting many of the other  
3 provisions in the Settlement Agreement that are intended to enable APS to improve that situation..

4 Paragraph 10.3 provides that, if modifications are made to Schedule 3 (such as providing for a  
5 "free footage" allowance), the signatories have agreed that offsetting revenue changes would be made  
6 that are revenue neutral to the Agreement. The Company has projected Schedule 3 revenue of \$23  
7 million in 2010.<sup>96</sup> Restoration of the 1,000 free footage allowance would likely increase the base rate  
8 revenue requirement provided for in the Agreement by approximately \$6 million in 2010, \$6.8  
9 million in 2011 and \$10 million in 2012.

10 **2. The Settlement Agreement addresses many of the inequities and**  
11 **complaints regarding APS' current Schedule 3 tariff.**

12 Staff recognizes that the changeover from APS' former line extension tariff (which provided  
13 for free footage) to the current tariff has occasioned criticism of the new policy, not only from  
14 Pecora, who has intervened in this case, but also from others, who have lodged either formal or  
15 informal complaints.

16 The concerns identified by parties opposed to APS' current Schedule 3 tariff, other than  
17 restoration of "free footage", have been addressed by the Settlement Agreement's provisions. One of  
18 the provisions requires APS to put together a schedule of its charges that will be approved by the  
19 Commission and which will be made available to customers requesting line extensions in the future.<sup>97</sup>  
20 Under APS' old tariff there had been complaints when customers have received an estimate from  
21 APS without any detail in it.<sup>98</sup> The Proposed Agreement addresses these complaints (other than the  
22 request for a reinstatement of "free footage") by requiring specific modifications to Schedule 3, such  
23 as a clarified definition of local facilities, a schedule of charges, a requirement that customer quotes  
24 will be itemized, and refund procedures.<sup>99</sup> Staff suggests that these modifications directly address  
25 many of the complaints. Reinstatement of "free footage" at this time is unwarranted and would undo  
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27 \_\_\_\_\_  
28 <sup>96</sup> *Id.* at 352.

<sup>97</sup> *Id.* at 1696.

<sup>98</sup> *Id.* at 1695.

<sup>99</sup> (Proposed SA at 18-19, ¶ 10.7).

1 some of the positive benefits of the current policy, but ultimately is up to the discretion of the  
2 Commission.

3 At the evidentiary hearing, APS went beyond the requirements of the Settlement Agreement  
4 to address the final area of customer complaint, the ability to have electrical work performed by  
5 qualified third-party contractors.<sup>100</sup> APS stated that it was looking at the policies in other states to see  
6 how that type of practice would be best implemented in Arizona.<sup>101</sup> APS recommended that the  
7 Commission hold a workshop to review this matter, or the use of third-party contractors for other  
8 portions of the work, and to work out the specifics of any such policy and to set parameters which  
9 would govern the use of such third- party contractors.<sup>102</sup>

10 **3. Treating Schedule 3 receipts as revenue is a reasonable outcome in the context of**  
11 **the significant regulatory challenges that APS presents.**

12 The Proposed Agreement continues the current policy of eliminating free footage, thereby  
13 requiring the applicant for electric service to pay the entire cost of the extension.<sup>103</sup> The Proposed  
14 Agreement also provides for APS to record its proceeds from Schedule 3 as revenue, instead of  
15 CIAC, during the period beginning January 1, 2010 through the earlier of December 31, 2012 or the  
16 conclusion of APS' next permanent rate case.<sup>104</sup> The revenue treatment of Schedule 3 proceeds  
17 automatically reverts to CIAC thereafter, unless otherwise ordered by the Commission.<sup>105</sup>

18 The Proposed Agreement also recognizes that the Schedule 3 accounting treatment has the  
19 potential to place certain upward pressures on rates in future rate cases.<sup>106</sup> For example, treating  
20 Schedule 3 receipts as revenue instead of CIAC will, all other things held equal, tend to increase rate  
21 base and thereby increase rates.<sup>107</sup> In addition, there are also potential rate case issues associated  
22 with switching back to CIAC,<sup>108</sup> and there are also likely to be parties who will urge the Commission  
23 to retain the revenue treatment indefinitely<sup>109</sup> Staff believes that CIAC is the better treatment over

24 <sup>100</sup> *Id.* at 656.

25 <sup>101</sup> *Id.* at 657.

26 <sup>102</sup> *Id.*

27 <sup>103</sup> Proposed SA at 18, ¶ 10.3.

28 <sup>104</sup> *Id.* at 18, ¶ 10.1.

<sup>105</sup> (Proposed SA at 17-18 ¶¶ 10.1, 10.4).

<sup>106</sup> (*Id.* at 13, ¶ 3.10; Tr. at 767, 1781-86, 1837-38. (Guldner, R. Smith, Abinah)).

<sup>107</sup> (Ex. S-11 at 15; Tr. at 1709).

<sup>108</sup> (Tr. at 767)

<sup>109</sup> (Tr. at 765).

1 the long-term, and Staff is naturally concerned about the impact of these various issues in the next  
2 rate case. Staff, however, found these aspects of the Proposed Agreement to be acceptable because of  
3 two main considerations: 1) rate cases typically present a variety of issues, and there are likely to be  
4 certain downward pressures on rates as well; and 2) most important of all, there are broad and  
5 continuing concerns about APS' financial health that the Proposed Agreement takes affirmative steps  
6 to address.

7 To a great extent, it is difficult to predict the issues that future rate cases will present and, of  
8 course, it is even more difficult to predict their outcomes. Although we may be able to identify the  
9 general effects associated with certain regulatory or accounting treatment proposed in the settlement,  
10 it is impossible to know precisely how those issues will develop in future rate cases. That said, the  
11 Proposed Agreement and the testimony in support of it identify the areas that may tend to increase  
12 rates in the future, such as the Schedule 3 revenue treatment.<sup>110</sup> Nonetheless, there are also features  
13 that would tend to put downward pressure on rates, such as the expense reductions and certain aspects  
14 of the Palo Verde depreciation rate issue.<sup>111</sup> Under these circumstances, Staff concluded that the  
15 concerns associated with APS' ongoing financial health and the potential for the Proposed Agreement  
16 to positively address those issues outweighed the future rate case issues associated with the Proposed  
17 Agreement in general, as well as the Schedule 3 accounting treatment in particular.

18 It is no secret that the Commission—and by extension its Staff—faces continuing challenges  
19 with the regulation of APS. The Company remains at the lowest investment grade rating,<sup>112</sup> despite  
20 having been granted rate relief in many forms including base rate increases, emergency increases, and  
21 despite having been the recipient of a PSA that not only includes demand charges but also sets the  
22 PSA rate on a forward-looking basis.<sup>113</sup> One may wonder why APS remains in this position,<sup>114</sup> but  
23 the potential remains that APS may be but one “disaster” away from a downgrade to a below  
24 investment grade bond rating. And it is important to note that any impending “disaster” may be  
25 unpredictable and not within the control of APS. The risks accompanying APS' precarious financial

26 <sup>110</sup> See Proposed SA at 13-14, ¶ 3.10; Ex. S-11 at 15; Tr. at 1697; Tr. at 1075-76.

27 <sup>111</sup> (Proposed SA at 15-17, ¶¶ 7.1-7.4; 19-20, ¶¶ 11.1-11.5; Tr. at 1075).

28 <sup>112</sup> (Tr. at 315).

<sup>113</sup> (Tr. at 196-98; Dec. No. 69663).

<sup>114</sup> The Proposed Agreement's section dealing with “Performance Measures” and the associated reporting and benchmarking requirements are all examples of efforts to address this unanswered question. See Proposed SA at 21-25, ¶¶ 13.1-13.9.

1 condition remain. Specifically, if a downgrade were to occur, the costs to APS' ratepayers could be  
2 significant.<sup>115</sup>

3 One might be tempted to argue that APS' repeated rate case filings over the past four to five  
4 years are an example of overreaching, but one must also acknowledge that the Commission has  
5 granted rate relief in every case. And the Commission's process for evaluating rate cases is very  
6 rigorous, so it is not reasonable to conclude that APS' filings have been entirely frivolous. In these  
7 circumstances, to conclude that the continued ordinary processing of APS' rate cases will adequately  
8 address APS' ongoing problems appears unrealistic. It was in this context that Staff approached the  
9 settlement process, and it was in this context that Staff ultimately determined that treating Schedule 3  
10 receipts as revenues for this limited period is reasonable.

11 Concern was raised at the hearing regarding the Company's incentive to gold plate if they can  
12 suddenly treat contributions as revenues. Staff witness Smith stated that by increasing its cost  
13 estimates that are provided for line extensions, the company could theoretically increase its revenue,  
14 which would be a benefit to the company and that would also have the result of increasing rate  
15 base.<sup>116</sup> But Smith also testified that there are a number of countervailing safeguards in place and  
16 there are some other regulatory remedies that would be available if the company were somehow  
17 imprudently incurring excessive costs for line extensions.<sup>117</sup> One of the safeguards is regulatory lag  
18 which would provide some incentive for the company not to gold plate.<sup>118</sup> Another safeguard is that  
19 going forward the company will have a schedule of charges for Schedule 3 and they will present the  
20 customer with an itemization of the costs. That's something that was lacking in the past.<sup>119</sup> It would  
21 also appear contrary to reasonable business practices for APS to start attempting to overcharge for  
22 line extensions when this aspect of the company's business is receiving such intense regulatory  
23 scrutiny.<sup>120</sup>

24 There was concern expressed at the hearing that under the current no free footage policy and  
25 accounting for the Schedule proceeds as revenue, that some customers would be paying twice.<sup>121</sup>

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26 <sup>115</sup> (Tr. at 3150.

27 <sup>116</sup> *Id.* at 1688.

<sup>117</sup> *Id.*

28 <sup>118</sup> *Id.* at 1689.

<sup>119</sup> *Id.*

<sup>120</sup> *Id.* at 1690.

<sup>121</sup> Tr. at 268.

1 This is a legitimate concern for an individual customer who pays APS for a line extension because  
2 APS will record the receipt as revenue and not offset rate base, so the customer-funded line extension  
3 would become a part of rate base and APS would earn a return on it. However, Staff believes that  
4 such concerns are outweighed by the other policy considerations, including having the cost causer  
5 pay for growth (the new line extension) and minimizing the overall revenue requirement impact on  
6 the millions of existing APS customers. There is also a theoretical justification for such treatment in  
7 the ratemaking process that continues to apply, even though APS will be applying an unusual  
8 accounting treatment (recording Schedule 3 receipts as revenue)\_ for the limited time period  
9 specified in the Agreement. When a person hooks up to the system and takes new service, the rates  
10 they are paying are designed to recover the cost of the existing system.<sup>122</sup> They are paying for the use  
11 of the rest of the distribution system that is bringing power to the extension as well as paying for their  
12 share of the transmission system and generation system.<sup>123</sup> Thus a person is not paying twice because  
13 they are receiving in their basic rates the same system service as everybody else is.<sup>124</sup> The payment  
14 for the new line extension is for a new or incremental cost to the system and the new customer  
15 requesting the new line extension, i.e., the cost causer, pays for that incremental cost, as specified in  
16 the terms of Schedule 3.<sup>125</sup> Thus, from a system-as-a-whole perspective, there is no double payment,  
17 although from the perspective of the new individual customer who funds the new line extension, it  
18 could appear to them as if they were paying not only for the cost of the new line extension and then  
19 paying APS a return on and of the plant (the new line extension) that their Schedule 3 payment had  
20 funded.

21 In summary, the Schedule 3 accounting treatment is a key provision of the Proposed  
22 Agreement because it bridges the gap between parties, such as Staff, who desire a base rate increase  
23 no larger than \$344 million, and the Company, which believes that it needs a mechanism to enhance  
24 revenues during the outlying years of the stay-out period. Staff believes that the Proposed Agreement  
25 as a whole is a means to begin to address the underlying causes of APS' low bond rating situation and  
26 repeated rate case filings.

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27 <sup>122</sup> *Id.*

28 <sup>123</sup> *Id.*

<sup>124</sup> Tr. at 268-69.

<sup>125</sup> Tr. at 269.

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**5. The Commission should examine any changes to the no free footage commission policy in the context of a workshop where all interested and affected parties can participate.**

If the Commission were to reconsider its current line extension policy, one approach would be to retain the current policy for the present and for purposes of resolving the APS rate case by adopting the proposed Agreement, but to convene workshops for the purpose of studying the issues and developing a policy. This approach would sidestep the issues that might be presented by attempting to change a key provision of the settlement agreement, and would also allow the Commission to reconsider the treatment of Schedule 3 in a more comprehensive way. Staff would note that such workshops could be completed in time to incorporate the results into APS' next rate case.

The information attached to Chairman Mayes' August 5, 2009 letter as well as the attachment to Staff Witness Abinah's Reply Testimony shows a wide range of approaches being used with respect to new growth. AECC Witness Higgins observed that neighboring states tend to have an approach that sets a dollar amount, and the dollar amount is in the range of several hundred dollars to upwards of \$1100.00.<sup>126</sup> Mr. Higgins supports a dollar allowance as opposed to the 1,000 free footage allowance requested by Ms. Pecora for the following reasons:

**A. (Mr. Higgins)...**I think that a dollar allowance is a more even-handed approach if you are going to have this type of policy. That, is, if you are going to have some type of subsidized hookup, then expressing it in dollars gives everyone who is hooking up the same treatment rather than the varying results that occur based on footage.

And so I believe that is probably the reason the other states have gone to a dollar amount. It also obviously provides very specific levels of exposure for the other customers who will be picking up the cost of this.

So I think for those two reasons, you know, it treats everyone the same who is hooking up, and it limits the exposure, are probably the other reasons the states went with that.

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<sup>126</sup> *Id.* at 258-59.

1           **Q. (Chairman Mayes)** And, it allows both the consumer, the homeowner  
 2           who is attempting to extend, some certainty in knowing what they are  
 3           going to get and what they are not going to get; they know they will get  
 4           \$1,000 or \$750, and it allows the utility an opportunity to budget. I  
 5           mean, it says, you know, we know that if we are going to have x  
 6           number of attempts to hook up outside away from our back bone  
 7           infrastructure, this is what it's going to cost our ratepayers?

8           **A. (Mr. Higgins)** Yes.<sup>127</sup>

9           A workshop would also be the best way to make any policy change to the Commission's  
 10          current line extension tariff because changes to the Commission's policy will affect not just APS, but  
 11          other companies as well that the Commission regulations.

12          **V. THE PROPOSED AGREEMENT SUBJECTS APS TO IMPORTANT**  
 13          **PERFORMANCE MEASUREMENTS.**

14          The Company will be subject to periodic evaluation through Performance Measurements and  
 15          Reporting Requirements as well as paying for the conduct of a Benchmarking Study of its operations  
 16          and cost performance. Moreover, APS' ability to pay Company executives incentive compensation  
 17          in excess of the test year level has been linked to satisfying the Performance measurements if the  
 18          incentives are to be recovered from ratepayers.

19          The Agreement establishes various means of periodically evaluating APS' performance to  
 20          promote the efficient operation of the utility. Performance Measurement criteria are set that require  
 21          APS to meet several objectives including the implementation of school renewable programs that  
 22          result in 50,000 MWhs of annual energy generation or savings; compliance with energy efficiency  
 23          goals; meeting goals set by the Renewable Energy Standard and Tariff rules; achieving its required  
 24          \$30 million average annual reduction to operational expenses over the term of the Agreement;  
 25          achieving a designated debt level within its capital structure; completion of the \$700 million equity  
 26          infusions that are part of the Agreement; and compliance with the reporting requirements and  
 27          cooperation in the conduct of the Benchmarking Study.<sup>128</sup>

28          Additionally, the Agreement links satisfaction of these Performance Measurements to APS'  
 29          executives' eligibility to receive annual cash incentive compensation in excess of the test year

<sup>127</sup> *Id.* at 260.

<sup>128</sup> (Proposed SA at 21-22, ¶ 13.2).

1 levels.<sup>129</sup> Pursuant to the Settlement, APS executives cannot receive additional incentive  
 2 compensation unless APS successfully achieves each Performance Measure so far as it is applicable  
 3 to the particular year or the Commission grants a hardship waiver from failure to meet one of the  
 4 Performance Measures.<sup>130</sup>

5 To the extent that there is a concern that APS will ignore the Performance Measures and  
 6 payout the incentive regardless, RUCO witness Dr. Ben Johnson suggested that would be unlikely.

7 [Y]es, I understand there is a provision theoretically they could still pay  
 8 themselves big bonuses and just say, you know, notwithstanding this  
 9 agreement we are going to do it. But we have seen what happened with  
 10 AIG and other companies that try to do that. That fallout is far too  
 11 great. So I don't think that the top executives of this company would  
 12 do that. I think what they are going to do is try very hard to achieve  
 13 these performance measures, and I think they are going to be able to  
 14 succeed.<sup>131</sup>

15 In conjunction with the Performance Measures, the Settlement builds on a preliminary study  
 16 of APS' performance relative to the industry. Under the Proposed Agreement, APS will pay for, and  
 17 not be reimbursed by ratepayers, a benchmarking analysis to be performed.<sup>132</sup> The minimum scope  
 18 of the study will include various forms of operational, cost, and financial performance.<sup>133</sup> RUCO  
 19 witness Jodi Jerich explained the benefit of the benchmark study is that, parties will be able to  
 20 measure and monitor agreed upon criteria under circumstances where potential deterioration in one  
 21 category of performance can be examined without unnecessary fear of recriminations. "[I]t is a way  
 22 of moving away from confusion and suspicion towards one of facts and discussion of what is really  
 23 going on."<sup>134</sup>

24 **VI. THE PROPOSED AGREEMENT PROMOTES IMPORTANT POLICY OBJECTIVES**  
 25 **OF THE COMMISSION.**

26 **A. Renewable Energy Provisions.**

27 Certain aspects of the Proposed Agreement promote public policy objectives of the  
 28 Commission in expanding the use of renewable energy and improving energy efficiency. Although a

<sup>129</sup> *Id.* at 20-21.

<sup>130</sup> *Id.*

<sup>131</sup> *Id.* at 1940.

<sup>132</sup> (Proposed SA at 27, ¶ 13.8.

<sup>133</sup> *Id.* at 25-26, ¶ 13.7

<sup>134</sup> (Tr. at 1937).

1 rulemaking was utilized to put the Renewable Energy Standard (“RES”) in place, the Proposed  
 2 Agreement obligates APS to surpass the levels of electricity produced by renewable sources set by  
 3 the RES.<sup>135</sup> As APS witness Barbara Lockwood explained, “[T]his settlement agreement is concrete  
 4 and specific. It’s an obligation to double the RES by 2015...”<sup>136</sup> Moreover, this requirement will  
 5 exist irrespective of judicial challenges to the RES rules.<sup>137</sup>

6 The Proposed Agreement outlines several specific objectives that promote the development of  
 7 renewable programs. APS will be required to pursue new in-state wind projects as well as a new  
 8 utility scale photovoltaic generation project.<sup>138</sup> Likewise, APS must take at least one new  
 9 transmission line or upgrade that has been identified by the report ordered in the 2008 Biennial  
 10 Transmission Assessment (Dec. No. 70635 (Dec. 11, 2008)) and then build it after designing and  
 11 obtaining permits and authorization for it.<sup>139</sup>

12 The Proposed Agreement also promotes the use of renewables by two groups that are not as  
 13 financially well positioned to take advantage of current tax incentives that make certain renewable  
 14 projects cost-effective. Within 120 days of Commission approval of the Settlement Agreement, APS  
 15 will file a Schools Solar Program. “Clearly, it’s beneficial for the state of Arizona to be able to -- for  
 16 schools to be able to reduce their expenditures on power, or on anything else, so that the monies can  
 17 be used more directly for instructional purposes.”<sup>140</sup> Specifically, the Schools Solar Program will  
 18 include an elimination of upfront costs for grade K through 12 public and charter schools.<sup>141</sup> The  
 19 schools program will have a goal of installing 50,000 MWh of annual energy generation or savings  
 20 within three years of Commission approval of the program.<sup>142</sup> In conjunction with the School  
 21 Facilities Board, APS will determine a prioritization of projects giving consideration to various  
 22 criteria that will emphasize need for the project.<sup>143</sup> *Id.*

25 <sup>135</sup> (Ex. APS-24 at 2).

26 <sup>136</sup> (Tr. at 1518).

27 <sup>137</sup> Proposed SA at 34, ¶ 15.8; Ex. APS-24 at 4.

28 <sup>138</sup> Proposed SA at 32, ¶¶ 15.2, 15.3.

<sup>139</sup> Tr. at 1032-33.

<sup>140</sup> *Id.* at 1323-24.

<sup>141</sup> Proposed SA at 33, ¶ 15.5; Ex. APS-24 at 8.

<sup>142</sup> Proposed SA at 33, ¶ 15.5.

<sup>143</sup> *Id.*

1 Likewise, APS will file a similar plan for governmental institutions that will substantially  
 2 reduce or eliminate upfront costs.<sup>144</sup> In conjunction with the governmental program, APS will  
 3 provide an opportunity for interested stakeholders to provide input on the proposal.<sup>145</sup>

4 **B. Demand-Side Management (“DSM”).**

5 The Proposed Agreement also strengthens APS’ Demand-Side Management (“DSM”)  
 6 program. Approval of the Proposed Agreement will establish energy efficiency goals of an annual  
 7 energy savings of 1.0% in 2010, 1.25% in 2011, and 1.5% in 2012.<sup>146</sup> These represent the first  
 8 energy savings goals for any utility in Arizona as opposed to the ordinary establishment of annual  
 9 DSM spending targets.<sup>147</sup> In terms of total energy saved, the cumulative impact of meeting these  
 10 goals would be 1,210,000 MWhs over the course of the three years between 2010 and 2012.<sup>148</sup>

11 Establishment of an energy efficiency standard is the objective of a pending rule-making in  
 12 Docket No. E-00000J-08-0314. As with the renewable goals set within the Settlement, these goals  
 13 will remain in place irrespective of the result of the rule-making process.<sup>149</sup> The exception, however,  
 14 would be that if the rule-making establishes a more stringent standard, that standard will supersede  
 15 the efficiency goals that are set within the Proposed Agreement.<sup>150</sup>

16 The Proposed Agreement also includes provisions to incentivize APS toward achieving the  
 17 efficiency goals by providing a greater incentive to the utility for more closely achieving the targeted  
 18 energy savings.<sup>151</sup> Consequently, APS may experience varying degrees of incentive (calculated as a  
 19 percentage of net benefits) between 0% and 10%.<sup>152</sup> Under the existing program, APS receives “10%  
 20 of net benefits capped at 10% of program costs, regardless of the level of savings achieved.”<sup>153</sup>  
 21 Further, “[t]here is a performance incentive that encourages us to maximize the savings and net  
 22 benefits to our customers.”<sup>154</sup> The result of the change to the incentive structure is that APS will  
 23

24 <sup>144</sup> Proposed SA at 33, ¶ 15.6; Ex. APS-24 at 7-8.

25 <sup>145</sup> *Id.*; Ex. APS-24 at 8.

26 <sup>146</sup> Proposed SA at 27, ¶ 14.1.

27 <sup>147</sup> Ex. APS-25 at 2, 6.

28 <sup>148</sup> *Id.* at 5.

<sup>149</sup> *Id.* at 7.

<sup>150</sup> *Id.*

<sup>151</sup> Proposed SA at 27-28, ¶¶ 14.1, 14.2.

<sup>152</sup> *Id.*

<sup>153</sup> Ex. APS-25 at 7.

<sup>154</sup> Tr. at 1657.

1 necessarily apply its efforts on the most effective programs from a customer perspective for APS to  
2 receive the most incentive.<sup>155</sup>

3 In order to meet these new efficiency targets, the Settlement requires APS to develop various  
4 new DSM program enhancements.<sup>156</sup> These enhancements will be enacted through an Energy  
5 Efficiency Implementation Plan.<sup>157</sup> As APS witness Mr. James Wontor explained:

6 APS will be proposing to introduce the following program  
7 enhancements in 2010: a residential high performance new construction  
8 program element, a home performance program element, additions to  
9 its current low income weatherization program, a non-residential high  
10 performance new construction program element, a customer repayment  
11 financing feature, and a specific target for the number of schools  
12 served. In addition to these elements, additional enhancements may be  
13 proposed in future years.<sup>158</sup>

14 Some may argue that the Agreement does not go far enough. But the Settlement struck an  
15 appropriate balance because while DSM provides good long-term benefits, it also costs money in the  
16 near term.<sup>159</sup> When performing cost-effective DSM, that is generally being measured against supply  
17 resources that have lives that may last 35 or 40 years and whose cost recovery occurs over 35 or 40  
18 years, and yet the DSM cost to avoid that supply gets expensed in the current year.<sup>160</sup> So you have to  
19 consider the near-term expenditure and the cost burden for the current customer when you are  
20 balancing your DSM program.<sup>161</sup>

## 21 **VII. THE PROPOSED AGREEMENT CONTAINS OTHER BENEFITS FOR** 22 **RATEPAYERS.**

23 Staff supports the Settlement because of the benefits presented within the Agreement on the  
24 balance outweighed the costs. As Staff witness Mr. Elijah Abinah explained, "negotiation is a  
25 process of give-and-take. We gave a little; we took a lot."<sup>162</sup> Staff believes that the Proposed  
26 Agreement contains numerous provisions to help ratepayers generally as well as specific terms to  
27 benefit low income customers in particular.

28 <sup>155</sup> *Id.*

<sup>156</sup> Proposed SA at 30, ¶ 14.10.

<sup>157</sup> *Id.*

<sup>158</sup> Ex. APS-25 at 10-11.

<sup>159</sup> Tr. at 249.

<sup>160</sup> *Id.* at 249-50.

<sup>161</sup> *Id.* at 250.

<sup>162</sup> *Id.* at 1801-02.

1           **A.     Withdrawal Of APS' Proposed Systems Facilities Charges And Impact Fee.**

2           APS also withdrew its requests for other components of the original application which would  
3 have created new fees and charges for ratepayers. APS withdrew its proposed Impact Fee as well as  
4 its System Facilities Charge under Section X, paragraph 10.5 and 10.6 of the Agreement.<sup>163</sup> The  
5 Impact Fee was anticipated to generate \$53 million from ratepayers hooking into APS' system in the  
6 first year of operation.<sup>164</sup> The System Facilities Charge was expected to generate a further \$6.6  
7 million from ratepayers in 2010, \$6.7 million in 2011, and \$12 million in 2012.<sup>165</sup> Clearly, between  
8 the reduction to the originally proposed base rate increase and the avoidance of various fees that APS  
9 requested, the Settlement avoids significant additional increases to ratepayers.

10           **B.     Reductions To System Benefit Charge.**

11           The Proposed Agreement makes possible rate savings to ratepayers by way of a reduction to  
12 the System Benefit Charge ("SBC") without an additional rate proceeding.<sup>166</sup> APS is approved to  
13 charge customers the SBC, in part, to fund the decommissioning trust for the Palo Verde nuclear  
14 generating station. APS is presently applying to the Nuclear Regulatory Commission for an  
15 extension of its Palo Verde license. Because the collection of decommissioning funds is calibrated to  
16 when the useful life of the plant will end, grant of the extension would distribute future contributions  
17 into the trust over a longer period and thereby reduce the level of payments that must be made.<sup>167</sup>  
18 Once the license extension is granted, APS will file with the Commission a revised nuclear  
19 decommissioning funding requirement which will reflect the reduction to the SBC as well as a  
20 reduction to the PSA.<sup>168</sup>

21           **C.     Retention Of The 90/10 Sharing Provision Of The PSA.**

22           The Agreement retains the 90/10 sharing provision of the PSA.<sup>169</sup> *Id.* at 15. Retention of the  
23 sharing provision is a benefit to ratepayers insofar as it maintains pressure on APS to be efficient and  
24 control costs rather than indiscriminately buying replacement power at expedient but uneconomical  
25

26           <sup>163</sup> Proposed SA at 18.

27           <sup>164</sup> Tr. at 661-2.

27           <sup>165</sup> *Id.* at 662.

27           <sup>166</sup> Tr. at 1028.

28           <sup>167</sup> Proposed SA at 19, ¶ 11.1; Tr. at 1066-67.

28           <sup>168</sup> Proposed SA at 20, ¶ 11.4.

28           <sup>169</sup> *Id.* at 15, ¶ 6.1.

1 prices.<sup>170</sup> It provides an incentive for management to purchase power and to purchase fuel as cost  
2 effectively as possible within the practical limits of a regulatory scheme.<sup>171</sup>

3           So the point is the 90/10 is a good policy. And part of the reason it  
4 works is it tends to be focused on the immediate decisions management  
5 is making and there's time for review by the Commission for prudence  
6 and other concerns. And as long as it's not a long-term concern, there  
7 was not imprudence, then eventually we step in and customers will  
8 reimburse the full 100 percent.<sup>172</sup>

9 Elimination of the 90/10 sharing would ultimately put more risk on customers than a system where  
10 when costs are rising the Company has to absorb some of it. When costs are coming down, it  
11 averages out, in that the Company gets to keep some of the money and help cancel out some of the  
12 earlier losses. The part the Company can control, is the decision to buy from this vendor or that one  
13 on a 30-day contract or a 120-day contract. Ten percent of that decision will affect the Company's  
14 earnings per share and it's not simply being passed through.<sup>173</sup>

15           There was concern that the provision has actually the potential to cut against the interests of  
16 ratepayers in this case given the probability that has been discussed for APS to over-collect its fuel  
17 costs in base rates.<sup>174</sup> It was pointed out that the mechanism is in the best long-run interests of  
18 ratepayers. When you have a period of declining costs, the mechanism works in a symmetrical  
19 manner. That's part of the decision the Commission made in setting rates. The Commission made  
20 the decision to have a symmetrical arrangement.<sup>175</sup> The Proposed Agreement includes an increase in  
21 base rates (that is rolling into base rates) something that was already in effect through the PSA.  
22 Somewhat analogous to the interim rate, that the interim rate has already been in effect and is on  
23 consumer's bills, but it will not become part of the permanent base rate through this decision. It's a  
24 roll over into base rates of a fuel expense. Ten percent has been absorbed by the Company and when  
25 new base rates are set at that point in time, the sharing ends, and the point from which to measure  
26 future sharing is re-set.<sup>176</sup>

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26 <sup>170</sup> Tr. at 1982-83.

27 <sup>171</sup> *Id.*

28 <sup>172</sup> *Id.* at 1985.

<sup>173</sup> *Id.*

<sup>174</sup> *Id.* at 2029-2030

<sup>175</sup> *Id.* at 2030.

<sup>176</sup> *Id.* at 2032.

1           **D.     Low Income And House Of Worship.**

2           The Proposed Agreement provides benefits to certain classes of ratepayers as well. It holds  
3 low income ratepayers harmless from the increase in rates, by not applying the base revenue increase  
4 to customers taking service on the E-3 and E-4 low income schedules.<sup>177</sup> Additionally, the  
5 Settlement requires APS to increase the existing bill assistance program by infusing \$5 million of  
6 shareholder money into the fund so as to assist customers whose incomes fall between 150% and  
7 200% of the Federal Poverty Income Guidelines.<sup>178</sup>

8           Likewise, Houses of Worship stand to benefit from approving the Settlement. Pursuant to  
9 Section XXI, paragraph 21.1, APS will unfreeze the Rate Schedule E-20 tariff for 12 months to allow  
10 additional Houses of Worship to participate.<sup>179</sup> According to APS witness David Rumolo, existing  
11 Houses of Worship that are not being served under Schedule E-20 would instead be served under  
12 Schedule E-32.<sup>180</sup> However, those customers stand to receive an average 20 percent decrease in rates  
13 by transitioning onto the E-20 tariff.<sup>181</sup>

14           **E.     New Rate Design Options**

15           The Proposed Agreement also contains several new rate design options designed to incent  
16 customers to use energy during off-peak hours. The Proposed Agreement creates an optional super-  
17 peak tariff for residential customers and other critical peak pricing rates. The Proposed Agreement  
18 provides for the development of Interruptible Rate Schedules and other Demand Response programs  
19 for large customers. Finally, it provides for a new optional time of use rate for schools.

20 **VIII. STAFF DOES NOT OBJECT TO ALLOWING APS TO CHANGE ITS BILL**  
21 **FORMAT.**

22           During the proceeding, some members of the public commented that APS' bills are confusing,  
23 basing their comments on the breakdown of the bill into various "unbundled" elements, along with  
24 their associated costs. The ALJ asked the parties to address whether APS should be required to  
25 continue to include all of its unbundled elements on its bills.<sup>182</sup>

26 \_\_\_\_\_  
27 <sup>177</sup> Proposed SA at 34, ¶ 16.1.

<sup>178</sup> *Id.* at 34, ¶ 16.2.

<sup>179</sup> *Id.* at 37, ¶ 21.1.

<sup>180</sup> Tr. at 2150.

<sup>181</sup> *Id.*

<sup>182</sup> *Id.* at 2150.

1 This specific breakdown of billing elements is the result of the Commission's efforts to  
 2 introduce retail electric competition to Arizona's electric industry in the late nineties. The Electric  
 3 Competition Rules set forth certain very specific billing requirements:

4 After the commencement of competition within a service territory  
 5 pursuant to R14-2-1602, all customer bills, including bills for Standard  
 6 Offer Service customers within that service territory, will list, at a  
 7 minimum, the following billing cost elements:

- 8 1. Competitive Services:
  - 9 a. Generation, which shall include generation-related billing and  
 10 collection;
  - 11 b. Competition Transition Charge;
  - 12 c. Transmission and Ancillary Services;
  - 13 d. Metering Services; and
  - 14 e. Meter Reading Services
- 15 2. Non-Competitive Services
  - 16 a. Distribution Services, including distribution-related billing and  
 17 collection, required Ancillary Services and Must-Run Generating  
 18 Units; and
  - 19 b. System Benefit Charges
- 20 3. Regulatory assessments; and
- 21 4. Applicable taxes.

22 A.A.C. R14-2-1612(O). To the best of Staff's knowledge, this rule is the primary basis for the  
 23 current format of APS' bill.

24 The Electric Competition Rules were the subject of extended judicial challenges. In 2004, the  
 25 Court of Appeals entered an opinion that upheld some of the rules and set aside some of the rules.<sup>183</sup>  
 26 Specifically, A.A.C. R14-2-1612(O), the rule quoted above that sets forth these very specific billing  
 27 requirements, was determined to be invalid because the Commission had not submitted it to the  
 28 Attorney General for review and certification.<sup>184</sup> Rule 1612(O) remains uncertified and therefore  
 remains invalid. Accordingly, this rule would not appear to be the source of any continuing  
 obligation related to APS' bill format.

<sup>183</sup> *Phelps Dodge v. Arizona Elec. Power Coop.*, 207 Ariz. 95, 128-29, 83 P.3d 573, 606-07 (App. 2004).

<sup>184</sup> *Id.* at 129, 83 P.3d at 607.

1           However, also as part of the Commission's efforts to introduce retail electric competition,  
 2 there were certain specific proceedings related to APS. Several of those culminated in a settlement  
 3 agreement, which was subsequently approved by the Commission.<sup>185</sup> That decision contains a brief  
 4 discussion of APS' bill format.<sup>186</sup> *See id.* at 11.

5           Apparently, there was some minor dispute in that proceeding about the format of APS' bill.  
 6 Subsequent Commission decisions also appear to have addressed APS' bill format.<sup>187</sup>

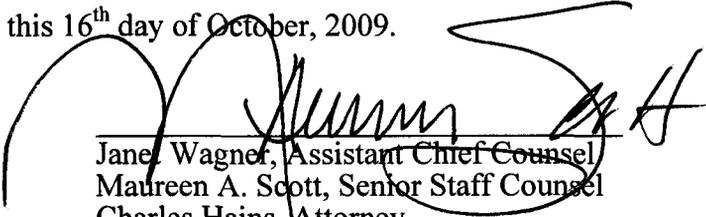
7           Clearly, this decision was entered for the purpose of implementing retail electric competition,  
 8 and the Commission's discussion and conclusions as to an appropriate bill format was conducted in  
 9 that context. To the best of Staff's knowledge, retail electric competition, at least as contemplated by  
 10 the Commission's electric competition rules, has not been implemented and is not currently in the  
 11 process of being implemented. It would appear, then, that these specific bill formatting requirements  
 12 may no longer serve the purpose for which they were designed. Under these circumstances, Staff  
 13 does not object to appropriate changes to APS' bill format.

14           Determining an appropriate bill format for APS may not necessarily be easy, and may well  
 15 raise various disputes among various parties, although Staff is not in a position at this time to predict  
 16 precisely what issues may be raised. Furthermore, to the extent that changing APS' bill format may  
 17 implicate previous Commission decisions, it is possible that A.R.S. § 40-252 may be implicated as  
 18 well.

19 **IX. CONCLUSION.**

20 Staff urges the Commission to adopt the Settlement Agreement for the reasons herein discussed.

21           RESPECTFULLY SUBMITTED this 16<sup>th</sup> day of October, 2009.

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28 <sup>185</sup> *See* Dec. No. 61973 (Oct. 6, 1999).

<sup>186</sup> *See id.* at 11.

<sup>187</sup> *See e.g.*, (2005 Settlement Order).

1 Original and thirteen (13) copies  
of the foregoing were filed this  
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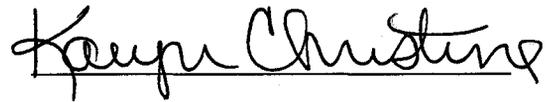
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