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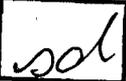
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November 20, 1998

Arizona Corporation Commission
DOCKETED

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Docket Control Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

DOCKETED BY 

RE: IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR APPROVAL OF ITS PLAN FOR STRANDED COST RECOVERY, DOCKET NO. E-01345A-98-0473, and

IN THE MATTER OF THE FILING OF ARIZONA PUBLIC SERVICE COMPANY OF UNBUNDLED TARIFFS PURSUANT TO A.A.C. R14-2-1601 et seq., DOCKET NO. E-01345A-97-0773, and

IN THE MATTER OF COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA, DOCKET NO. RE-00000C-94-0165.

Gentlemen:

Pursuant to the Chief Hearing Officer's Procedural Order of November 13, 1998, attached herewith for filing is the direct testimony and exhibits of Jack E. Davis, President of Energy Delivery and Sales for Arizona Public Service Company ("APS"). This testimony is concurrently being served on all parties of record.

Given the Commission docket numbers for this proceeding, APS assumes that the evidentiary record previously developed in these consolidated dockets will also be part of the evidentiary record upon which the Commission will base its decision in this proceeding. In that regard, APS would direct the parties' attention to the pre-filed testimony of its witnesses John H. Landon and William H. Hieronymus in the stranded cost proceeding which culminated in Decision No. 60977, issued June 22, 1998. A copy of that pre-filed testimony is also attached hereto and is being concurrently served on all parties. If a specific request for incorporation of this testimony into the record of this proceeding is necessary, APS hereby makes such a request pursuant to A.A.C. R14-3-109.

Sincerely,

Barbara A. Klemstine

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AZ CORP COMMISSION

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BEFORE THE
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ARIZONA CORPORATION COMMISSION

TESTIMONY OF JACK E. DAVIS

On Behalf of

Arizona Public Service Company

Docket No. E-01345A-98-0473, et al.

November 20, 1998

TABLE OF CONTENTS

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

Page

I. INTRODUCTION..... 1

II. BACKGROUND TO THE APS SETTLEMENT AGREEMENT..... 2

III. PROVISIONS OF THE APS SETTLEMENT AGREEMENT 4

IV. BENEFITS OF THE APS SETTLEMENT AGREEMENT..... 15

V. CONCLUSION.....21

SCHEDULE JED-1 STATEMENT OF WITNESS QUALIFICATIONS

SCHEDULE JED-2 APS SETTLEMENT AGREEMENT

SCHEDULE JED-3 UNBUNDLED TARIFFS

SCHEDULE JED-4 PHASE-IN PLAN

DIRECT TESTIMONY

OF

JACK E. DAVIS

(Docket No. E-01345A-98-0473, et al.)

I. INTRODUCTION

Q. WOULD YOU PLEASE STATE YOUR NAME AND BUSINESS ADDRESS?

A. My name is Jack E. Davis, and my business address is 400 North Fifth Street, Phoenix, Arizona 85004

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am President of Energy Delivery and Sales for Arizona Public Service Company ("APS" or "Company"). My educational and professional qualifications and experience are set forth in Schedule JED-1, which is attached to my testimony.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. In response to the Arizona Corporation Commission's ("Commission") Procedural Order of November 13, 1998, I will provide some of the historical background to the Settlement Agreement between the Commission's Utilities Division Staff ("Commission Staff" or "Staff") and APS dated November 4, 1998 ("APS Settlement Agreement" or "Agreement"). This Agreement can be found as Attachment JED -2 to my testimony. I will discuss and explain each of the various individual sections and provisions of the APS Settlement Agreement and outline why the Commission's timely approval of this Agreement is in the public interest.

1 **Q. WHAT ARE PRIMARY BENEFITS OF THE APS SETTLEMENT**
2 **AGREEMENT?**

3 A. There are at least a dozen that come to mind. These include:

- 4 (1) guaranteed price reductions;
- 5 (2) price stability and certainty for both bundled and unbundled rates;
- 6 (3) development of a competitive market through an appropriately designed MGC and
- 7 Adder;
- 8 (4) resolution of the stranded cost issue in a fair and equitable manner;
- 9 (5) incentives to both mitigate stranded costs and the cost of regulated services;
- 10 (6) the first steps toward creation of an Arizona Transco and/or regional ISO, as well
- 11 as assured creation of an ISA;
- 12 (7) promotion of efficient transmission network infrastructure and pricing principles;
- 13 (8) development of solar resources;
- 14 (9) assurance of divestiture of generation and other competitive services by APS in a
- 15 cost-effective manner;
- 16 (10) dismissal of APS litigation against the Commission;
- 17 (11) a code of conduct for affiliate relationships; and,
- 18 (12) the establishment of essential ground rules for competition to begin on schedule.
- 19

20 I will elaborate on each of these benefits later in my testimony

21

22

23 **II. BACKGROUND TO THE APS SETTLEMENT AGREEMENT**

24 **Q. COULD YOU DESCRIBE THE GENERAL SCOPE OF THE APS SETTLEMENT**
25 **AGREEMENT?**

26

1 A. Yes. The APS Settlement Agreement addresses a multitude of competition-related issues,
2 including standard offer rates, stranded costs, regulatory assets, unbundled rates for
3 customers choosing competitive electric service providers, cost mitigation, divestiture,
4 pending litigation between APS and the Commission, market structure, transmission
5 access and pricing, etc. Although it would be an overstatement to say that every electric
6 competition issue - past, present or future - has been resolved by the Agreement, it is truly
7 a global settlement of numerous critical issues that would have complicated, delayed or
8 even prevented the implementation of retail electric competition by January 1, 1999.

9
10 **Q. WHY DID APS AND COMMISSION STAFF ENTER INTO SUCH A GLOBAL**
11 **SETTLEMENT AGREEMENT?**

12 A. APS, Commission Staff and others have been negotiating for several months. Both Staff
13 and APS were acutely aware of the positions taken by various parties in the generic
14 stranded cost and other proceedings and attempted during their negotiations to
15 accommodate their such concerns where possible. The motivation on both sides for these
16 negotiations, which were widely known to be underway, were at least three fold. One
17 mutual goal was to avoid or minimize the seemingly endless contested hearings that would
18 have resulted had each of the matters contained in the APS Settlement Agreement not
19 been resolved through negotiation. For example, the previous "generic" stranded cost
20 hearings lasted for over two weeks. That effort would have had to have been multiplied
21 many fold to deal with the specifics of stranded costs, unbundled rates, etc., for APS. It
22 would have been literally impossible to complete all these hearings in time for the
23 beginning of electric competition in January of 1999. Moreover, no amount of evidentiary
24 hearings could have resulted in many of the additional benefits (such as the automatic rate
25
26

1 reductions or the withdrawal of litigation) realized by the Commission and consumers
2 under the Agreement. Third, APS and Commission Staff hoped to eliminate some of the
3 uncertainty currently hanging over the implementation of retail electric competition. This
4 would be accomplished by: (1) ending the various lawsuits by APS against the
5 Commission over A.A.C. R14-2-1601, *et seq.* ("the Electric Competition Rules"),
6 Decision No. 60977 (the "Stranded Cost Order"), and Decision No. 61071 ("Emergency
7 Amendments to the Electric Competition Rules"); (2) guaranteeing that standard offer
8 customers would see tangible benefits from the introduction of competition in the form of
9 guaranteed rate decreases; and (3) creating a mechanism allowing for a sustainable solar
10 program on the part of APS.
11

12
13 **Q. HAS APS PROVIDED AFFECTED PARTIES WITH REQUESTED
14 INFORMATION ABOUT THE APS SETTLEMENT AGREEMENT?**

15 A. Yes. The Residential Utility Consumer Office ("RUCO"), the Attorney General's Office
16 ("AG"), PG&E Energy Services Corporation ("PG&E"), Cyprus Climax Metals, et al.
17 ("AAEC") and others, have all sent data requests to the Company, and in some instances,
18 many sets of data requests. APS has responded to all these requests, almost always within
19 the 24-hour target established by the Commission's Procedural Order of November 6,
20 1998.
21

22 **III. PROVISIONS OF THE APS SETTLEMENT AGREEMENT**

23
24 **Q. WERE YOU PERSONALLY INVOLVED IN THE NEGOTIATIONS THAT LED
25 TO THE APS SETTLEMENT AGREEMENT?**

26 A. Yes. I was personally involved in these negotiations.

1 Q. **WOULD YOU PLEASE DESCRIBE THE VARIOUS PROVISIONS OF THE APS
2 SETTLEMENT AGREEMENT?**

3 A. Yes. However, before getting to the various enumerated sections of the APS Settlement
4 Agreement, I wish to draw attention to the "Statement of Intention" set forth at page 1 of
5 the Agreement. The language in the "Statement of Intention" is more than the usual
6 "lawyeres" boilerplate that is common to settlement agreements. In fact, the next to last
7 sentence of paragraph 4 goes to the essence of the Agreement, at least as far as the
8 Company is concerned: "This settlement is intended to be comprehensive, fair to APS, its
9 shareholders and customers and will serve to make an efficient and cost effective transition
10 to a new era of customer choice in a competitive market structure." Comprehensiveness,
11 fairness, efficiency, cost effectiveness – these are difficult and often contradictory
12 objectives, and yet the APS Settlement Agreement achieves these goals.

13 Section I:

14 Section I is standard language that requires the Commission to either accept or reject the
15 APS Settlement Agreement as a unitary document. It ensures that signatories to a
16 settlement get the benefit of their bargain.
17

18
19 Section II:

20 Section II deals with unbundled rates. Unbundled rates are essential to the operation of
21 retail electric competition. Commission Staff had numerous concerns with the Company's
22 original unbundled rate filing in February of 1998. The rates attached to my testimony as
23 Attachment JED-3 address those concerns and are the rates referred to in Section II.
24 They provide unbundled charges for generation, transmission, distribution, metering,
25 meter reading, billing, regulatory assets, and system benefits based on the Company's
26

1 Commission-approved rate structure and the embedded costs of those services. For those
2 customers choosing competitive generation from an authorized Electric Service Provider
3 ("ESP"), the generation component of the unbundled rate will receive a credit based on
4 the market price of generation (the "Market Generation Credit" or "MGC") plus an
5 average of an additional three mills per kWh (the "Adder"). What is left over after
6 subtracting the MGC and the Adder from the generation component of the rate, if
7 anything, is the so called "Competition Transition Charge" ("CTC"), which is treated as a
8 residual value. Under terms of the Agreement, the CTC completely ends after the year
9 2004 regardless of whether APS has additional stranded generation costs after that date.
10

11
12 The Adder was a Staff concept. Assuming an average market price in 1999 of 2.6¢/kwh,
13 the adder, on average, represents a 12% markup over such price. As such, it represents
14 both an intentional obstacle to the Company's recovery of stranded costs and an added
15 benefit to those customers taking competitive electric supply. Moreover, the Adder is
16 increased another 17% in 2000 if APS has not actually lost a fourth of its eligible load to
17 competitive suppliers. Beginning in the year 2003, the Adder can be further adjusted if
18 circumstances warrant so long as APS retains the same opportunity for stranded cost
19 recovery through 2004.
20

21
22 The Adder to the market price of power is adjusted by a customer's load factor.

23 Customers (or customer classes) with an annual load factor greater than APS' system
24 average load factor will receive less than the \$.003/kwh, and customers with a load factor
25 less than APS' system average will receive an Adder greater than \$.003/kwh. For
26

1 example, residential customers will receive an Adder of \$.0041/kWh, and a large
2 commercial customer with a load factor of 75% will receive an Adder of \$.0022/kWh.
3 The determination of the MGC will also recognize line losses that will be incurred to
4 deliver energy.

5
6 Exhibit A to the Agreement contains a reconciliation procedure for the MGC that prevents
7 over/under collection of stranded costs. In addition, the APS Settlement Agreement
8 requires the Company to reduce rates by the net of regulatory asset recovery and any
9 increased costs of service upon full amortization of regulatory assets. This is presently
10 scheduled for July 1, 2004.
11

12
13 Section III:

14 This Section merely reaffirms the Commission's prior Decisions regarding full recovery of
15 the Company's regulatory assets. Such Decisions recognized that the Commission has
16 made explicit regulatory promises for the recovery of regulatory assets. These assets have
17 no market value and therefore, by definition, can not be recovered through competitive
18 electric rates. APS' regulatory assets represent costs previously incurred by the Company
19 to provide service and benefits already conferred upon the Company's customers for
20 which APS has not been compensated in the rate-setting process.
21

22
23 Section IV:

24 This provision was another concession to Commission Staff. Staff was anxious for
25 Tucson Electric Power ("TEP") to acquire the Company's extra-high voltage ("EHV")
26

1 transmission lines as the first step towards creation of an Arizona transmission company
2 ("Transco") to eliminate any vertical market power concerns on the part of Commission
3 Staff and perhaps potential APS competitors. In return, TEP was willing to sell its interest
4 in two jointly-owned power plants, Four Corners and Navajo, for these EHV lines.

5 Transmission lines less than 345 kV are required to move power around and within the
6 APS distribution system and represent that part of the transmission system which APS is
7 obliged by contract to coordinate with SRP. Moreover, TEP had no particular interest in
8 these smaller transmission facilities.
9

10
11 The whole APS/TEP transaction is governed by a Memorandum of Understanding
12 ("MOU"), which was negotiated at arms-length between the two parties and is attached to
13 the APS Settlement Agreement as Exhibit B. Under terms of the MOU, APS and TEP
14 will negotiate a definitive agreement for the sale and purchase of assets within sixty days
15 of the issuance of a final, non-appealable order approving the APS Settlement Agreement
16 (and, of course, the Commission Staff's settlement agreement with TEP). It was
17 understood by APS, TEP and Commission Staff that there are contingencies necessarily
18 attached to the proposed asset sales. For one thing, jointly-owned generating facilities
19 (and transmission lines, for that matter) are subject to rights of first refusal by other
20 participants. This means, for example, that TEP may be forced to sell a part of its
21 interests in Navajo and Four Corners to other non-APS participants, such as Salt River
22 Project ("SRP"). Similarly, APS may be required to offer certain transmission facilities to
23 joint owners other than TEP. In addition to Commission authorization, the transaction is
24 subject to Federal Energy Regulatory Commission ("FERC") approval.
25
26

1
2 The MOU addresses these and other contingencies, and should APS be unable to sell its
3 EHV transmission system to TEP for reasons outside its control, APS retains the rights
4 under the MOU to sell (and will in fact sell) that system to another party. In either event,
5 APS will have divested itself of the means to control the import/export of power into/from
6 its service area. This divestiture, combined with FERC's Order 888 protections, will
7 assure all competitors in Arizona of non-discriminatory access to APS customers.
8

9
10 Section V:

11 This Section, along with Section VI, largely relate to transmission pricing issues. The
12 three primary objectives of Staff and APS in these Sections are: (1) the avoidance of
13 transmission rate "pancaking," where the end-user or the ESP must pay separate
14 transmission charges to every transmission owner between its supply source and the end-
15 user; (2) the prevention of cost-shifting between APS and TEP customers; and, (3) the
16 assurance to competitors of equal access to and use of the EHV transmission system. Just
17 as important as the rationalization of transmission pricing and access policies discussed
18 above is the support this Section provides towards formation of first an Arizona Transco
19 and eventually a regional ISO.
20

21
22 Section VI:

23
24 *See discussion of Section V above.*
25
26

1
2 Section VII:

3 APS agrees to guaranteed annual rate reductions of 1% for 1999 and 2000 for both
4 standard offer and unbundled rate customers and 1% in 2001 and 2002 for residential
5 standard offer customers. The cost saving incentive mechanism from the 1996 Rate
6 Reduction Agreement between APS and the Commission is continued through 2002. I
7 should note that this is the same mechanism that has already produced three successive
8 rate reductions. The APS Settlement Agreement will extend this string to at least seven
9 straight years of APS price reductions. The four reductions called for under the
10 Agreement will add to the more than \$300 million in benefits received by consumers from
11 the prior APS price reductions.
12

13
14 This Section of the APS Settlement Agreement also enlists the Company's support for the
15 Solar Portfolio Standard ("SPS") required by A.A.C. R14-2-1609. APS will obtain solar
16 resources through a competitive RFP process (over which the Commission exercises,
17 through the Utilities Division Director, effective "veto power") with the higher costs being
18 at least partially defrayed by implementation of a "green" solar rate. Under this proposal,
19 those APS customers interested in solar energy can receive solar electric power at a higher
20 rate than standard offer service. Any remaining increased costs of the SPS will be
21 deferred for recovery beginning no sooner than 2003. APS has long been concerned that
22 the mandatory nature of the SPS effectively gave a "blank check" to solar power for
23 which there was no cost-recovery assurance. The Agreement addresses both concerns by
24 requiring joint APS and Commission concurrence on the award of a solar procurement
25
26

1 contract and by using a combination of "green" rate revenues and cost deferrals to provide
2 a recovery mechanism for agreed upon SPS cost increases.

3
4 Section VIII:

5 APS drops its opposition to A.A.C. R14-2-1616 (A) and agrees to a firm timetable for
6 divestiture of its generating assets and for the creation of a marketing affiliate. As
7 permitted by Rule 1616 (A), the divestiture of generation will be to a new corporate
8 affiliate at the then book value of the assets involved. Because significant savings in the
9 divestiture process can be realized by APS by deferring divestiture until 2001, APS is
10 granted a two-year extension of the date set in Rule 1616 (A). These savings involve both
11 the avoidance of securing first mortgage bond holder approval and the exercise of certain
12 rights under the Palo Verde sale/leaseback agreement. Similarly, the requirements of
13 A.A.C. R14-2-1606 (B), i.e., competitive bidding of standard offer service (which were
14 clearly intended to dovetail with the divestiture requirement of Rule 1616), are also
15 deferred for two years.
16
17

18
19 APS has already formed the competitive marketing affiliate referenced in the Agreement
20 (APS Energy Services, Inc.) and has submitted to the Commission an application for a
21 competitive CC&N. By the end of November of 1998, APS will submit a Code of
22 Conduct for such affiliate.
23
24
25
26

1 Section IX:

2 APS commits to having an Arizona Independent [Transmission] Scheduling Administrator
3 ("ISA") in place by year-end 1998 and operational by April 1, 1999. In fact, creation of
4 the ISA has already been accomplished. APS further commits to work towards the
5 formation of an Independent [Transmission] System Operator ("ISO") by as early as
6 December 31, 2000. Both the ISA and, later, the ISO will facilitate open and equal access
7 to transmission facilities.
8

9
10 Section X:

11 There is no Section X in the APS Settlement Agreement. This was an inadvertent error in
12 numbering the Sections of the Agreement.
13

14 Section XI:

15 APS agrees to modification of its existing CC&N consistent with the Commission's
16 Electric Competition Rules (A.A.C. R14-2-1601, *et seq.*) and the APS Settlement
17 Agreement. In doing so, the Company effectively waives its right to contend in any later
18 judicial proceeding that APS was not afforded the A.R.S. Section 40-252 hearing required
19 prior to modification of its CC&N.
20

21 Section XII:

22 APS agrees to dismiss with prejudice all pending litigation against the Commission
23 involving the Electric Competition Rules. This includes a Superior Court action
24 challenging the 1996 Electric Competition Rules, Superior and Appellate Court challenges
25 challenging the 1996 Electric Competition Rules, Superior and Appellate Court challenges
26

1 to the Stranded Cost Order, and a Superior Court action against the Emergency
2 Amendments to the Electric Competition Rules. Where it is mutually agreed that such
3 assistance would be appropriate and helpful, APS pledges its support of the Commission
4 as regards any remaining competition-related litigation against the Commission.
5

6 Section XIII:
7

8 APS agrees that must-run power must be cost-of-service regulated. APS must-run units
9 include Ocotillo and West Phoenix (both located in the Valley), as well as Douglas and
10 Axis. Although APS believes that FERC will assert jurisdiction over must-run generating
11 units (either as incident to its approval of a regional ISO or because transfer of the must-
12 run units to an affiliate, as called for in the Agreement, will make any subsequent sale of
13 must-run power a "sale for resale"), this Section provides for Commission jurisdiction
14 over the sale of must-run output in the absence of preemptive FERC regulation.
15

16
17 Section XIV:

18 This Section calls for certain (but not all) of the waivers requested by the Company of the
19 Commission's general affiliate rules (A.A.C. R14-2-801, *et seq.*). I would note that these
20 provisions are not to be confused with the specific electric affiliate provisions of A.A.C.
21 R14-2-1617. I will not go through each of the partial waivers individually. Suffice it to
22 say that I understand they are the type of waivers that the Commission has routinely
23 granted to telecommunications companies with competitive affiliates.
24
25
26

1 Section XV:

2 Again, this is an inadvertent numbering error. There is no Section XV to the Agreement.

3
4 Section XVI:

5 Section XVI essentially approves the residential phase-in proposed by the Company on
6 September 15, 1998. A copy of the Company's plan is provided as Attachment JED-4 to
7 my testimony.
8

9
10 Section XVII:

11 Staff proposes to support certain clarifications to Rule 1616 (B) regarding competitive
12 services that can be offered by a utility distribution company. This section imposes no
13 specific obligation on APS.
14

15
16 Section XVIII:

17 This Section merely acknowledges that APS has entered into this Agreement and has
18 agreed to divest its EHV transmission system in exchange for the binding Commission
19 promise of recovery of regulatory assets and the recovery of stranded costs in accordance
20 with the terms of the Agreement.
21
22
23
24
25
26

1 **MISCELLANEOUS PROVISIONS:**

2 To borrow a phrase from my testimony in the APS/SRP Agreement proceeding (Docket
3 No. E-01345A-98-0245), most of this is the usual lawyer boilerplate, the significance of
4 which I will not attempt to explain.

5
6 **IV. BENEFITS OF THE APS SETTLEMENT AGREEMENT**

7
8 **Q. HAVE YOU PREVIOUSLY SUMMARIZED THE BENEFITS REALIZED**
9 **UNDER THE APS SETTLEMENT AGREEMENT?**

10 **A. Yes. I have also described many of them in the context of my discussion of the various**
11 **sections of the Agreement itself. However, for the convenience of the reader, I will list them**
12 **again:**

- 13
14 (1) guaranteed price reductions;
- 15 (2) price stability and certainty for both bundled and unbundled rates;
- 16 (3) development of a competitive market through an appropriately designed MGC and
17 Adder;
- 18 (4) resolution of the stranded cost issue in a fair and equitable manner;
- 19 (5) incentives to both mitigate stranded costs and the cost of regulated services;
- 20 (6) the first steps toward creation of an Arizona Transco and/or regional ISO, as well
21 as assured creation of an ISA;
- 22 (7) promotion of efficient transmission network infrastructure and pricing principles;
- 23 (8) development of solar resources;
- 24 (9) assurance of divestiture of generation and other competitive services by APS in a
25 cost-effective manner;
- 26 (10) dismissal of APS litigation against the Commission;

- 1 (11) a Code of Conduct for affiliate relationships; and,
2 (12) the establishment of essential ground rules for competition to being on schedule.
3

4 **Q. WOULD YOU FURTHER ELABORATE ON EACH OF THESE BENEFITS?**

5 **A. Yes.**

6
7 Guaranteed Rate Reductions:

8 Without the necessity of a full blown rate proceeding (taking a year or more for each
9 hoped-for rate reduction), APS has agreed to guaranteed annual rate decreases for each of
10 the next four years. Unlike the anticipated but as of yet unproven benefits of competition,
11 these are assured benefits for all customers, whether or not they participate in the
12 competitive electric market. In addition, the APS Settlement Agreement provides a
13 mechanism for yet an additional rate reduction upon the final amortization of the
14 Company's regulatory assets. Absent this voluntary commitment by the Company, these
15 guaranteed rate reductions would not otherwise be available to customers.
16

17
18 Unbundled and Bundled Rates:

19
20 Obviously, there could be no meaningful and informed customer choice without knowing
21 both the unbundled and bundled rates for electricity. Given that no hearings were even
22 scheduled on the Company's unbundled rate proposals, it appears impossible that any
23 unbundled rates could have been in effect by January 1, 1999 (except, of course, those
24 originally proposed by the Company last February), absent the Agreement. Moreover, it is
25 also helpful to both consumers and competitors if there is some assurance that these rates
26

1 will not be changing for some period of time, or at least that the only changes will be rate
2 reductions.

3 The APS Settlement Agreement provides that existing standard offer rates and the
4 unbundled rates set forth in Attachment JED-3 will remain in effect through at least the
5 year 2000. APS can, however propose (by September 30, 1999) a revenue neutral
6 restructuring of unbundled an/or standard offer rates upon which the Commission will
7 take action no later than December 31, 2000. Subject to these exceptions, which are set
8 forth in the Agreement, APS rates are fixed through 2002.
9

10
11 Development of Competitive Market:

12 A transparent market price is critical for a well-functioning competitive electric market.
13 This gives everyone the same "bogey" to shoot at. By using both the CPX and NYMEX
14 prices, the MGC agreed upon by Commission Staff and APS combines the strengths of
15 each of these alternative measures of market price. The addition of the Adder gives
16 competitors a margin to work with even if they are no better at acquiring cost-effective
17 electric supplies than the average market participant. I would also note that the
18 Company's concession to Staff on the design of unbundled rates, i.e., the use of embedded
19 costs for determining metering and billing credits, gives competitors additional profit
20 opportunities on top of whatever margins they can obtain for the electricity itself.
21
22
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1 Stranded Cost:

2 Resolution of this issue in a manner acceptable to the Company is why APS agreed to sell
3 its EHV transmission system, why APS is dismissing its litigation against the Commission,
4 why APS agreed to guarantee rate reductions, and why APS made all the other
5 concessions embodied in the Agreement. APS will get no stranded cost recovery after
6 2004 and, given the MGC, the Adder and the substantial rate reductions guaranteed under
7 the Agreement, will have to scramble to receive something even close to full recovery of
8 stranded costs prior to that cutoff.
9

10
11 Mitigation:

12 Since 1991, the Company has reduced rates four times, which have already served to
13 mitigate over 35% of the Company's otherwise strandable costs. Continuation of the cost
14 incentive mechanism from the 1996 Rate Reduction Agreement will continue to provide
15 powerful incentives to mitigate costs. Second, APS will have to further mitigate stranded
16 costs to account for both the Adder and the four additional rate reductions. Finally, the
17 2004 cutoff for stranded cost recovery is yet another incentive to reduce APS generation
18 costs as quickly as possible.
19

20
21 Transco:

22 Although FERC equal access provisions have been effective in thwarting any potential for
23 the exercise of vertical market power by jurisdictional transmission entities such as the
24 Company, APS has long supported the idea of an independent operator of essential
25 transmission facilities. That is why it helped create the Arizona ISA and is the biggest
26

1 booster of a regional ISO. Creation of TEP as a Transco can further facilitate this
2 independence and provides additional insurance against the possibility that a regional ISO
3 would fail to materialize despite the Company's best efforts.
4

5 Transmission Pricing:

6 Efficient transmission pricing can make or break effective competition. As I noted
7 above, APS is committed to fighting rate "pancaking" wherever possible. At the same
8 time, APS will support the creation of "zonal" rates so that existing APS customers do
9 not face higher transmission charges as a result of TEP's acquisition of the Company's
10

11
12 EHV system and, upon formation of an ISO, transmission pricing that will afford
13 efficient access for all competitors.
14

15
16 Solar Resources:

17 I previously discussed this element of the Agreement and reiterate the Company's
18 commitment to promote the current SPS. The provisions of the APS Settlement
19 Agreement provide both a check against overreaching by solar providers (through the
20 required RFP process) and an assured funding mechanism should voluntary consumer
21 participation in a "green" electricity program prove inadequate.
22
23
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1 **Divestiture:**

2 **APS will divest its EHV system, whether to TEP or to another unrelated party. APS will**
3 **further divest its generation and competitive electric marketing functions to separate**
4 **affiliates subject to the provisions of A.A.C. R14-2-1617.**

5
6 **Litigation:**

7 **No matter how confident the Commission may be in its legal position in its litigation with**
8 **the Company, the dismissal of existing litigation is clearly a benefit for both the**
9 **Commission and those supporting the Commission's Electric Competition Rules.**
10 **Moreover, the conservation of resources now being expended by both sides on this**
11 **litigation will allow them to concentrate on the already difficult task of implementing**
12 **electric competition, which I remind the Commission is only six (6) weeks away as of the**
13 **filing of this testimony.**

14
15
16 **Code of Conduct:**

17 **In addition to the Commission's various rules, APS will have in place a Code of Conduct**
18 **that should provide potential competitors with additional assurance that there will be no**
19 **improper or anti-competitive contacts between APS and its competitive affiliates.**

20
21
22 **Ground Rules for Competition:**

23 **This is really a summation of all the provisions of the APS Settlement Agreement. They**
24 **provide for the first time the "flesh" on the "framework" for electric competition first**
25 **erected in 1996. APS is now prepared for real competition to begin.**

V. CONCLUSION

1
2 **Q. IN CONCLUSION, WOULD YOU SUMMARIZE YOUR MAJOR POINTS?**

3
4 **A. The APS Settlement Agreement provides benefits not achievable in any other way. It is a**
5 **balanced Agreement that “clears the decks” for the beginning of retail electric competition**
6 **in 1999. Such a global settlement was the result of months of painful “give and take”**
7 **negotiations. I urge the Commission to evaluate and approve the APS Settlement**
8 **Agreement as a fully intergrated document with mutually interdependent provisions rather**
9 **than allow others to nitpick the Agreement to pieces.**

10
11
12 The alternative to the APS Settlement Agreement is to schedule hearings on all the
13 contested issues resolved by the APS Settlement Agreement. This will delay for months
14 the implementation of competition and could well result in even more costly litigation.

15
16 APS urges the Commission to approve the APS Settlement Agreement. It is fair,
17 comprehensive, and clearly in the public interest.

18
19 **Q. DOES THIS CONCLUDE YOUR DIRECT WRITTEN TESTIMONY?**

20 **A. Yes.**
21
22
23
24
25
26

ARIZONA PUBLIC SERVICE COMPANY, INC.

DOCKET NO. E-01345A-98-0473

DOCKET NO. E-01345A-97-773

DOCKET NO. RE-00000C-94-0165

SETTLEMENT AGREEMENT

The undersigned parties stipulate and agree to the following settlement provisions in connection with the following applications submitted to the Arizona Corporation Commission ("Commission") by Arizona Public Service Company, Inc. ("APS" or "Company"): Docket No. E-01345A-98-0473 and Docket No. E-01345-97-773.

In addition, this Settlement Agreement ("Agreement") settles all issues arising from or related to the Commission's Electric Competition Rules as set forth in Decision Nos. 59943, 60977 and 61071.

Statement of Intention.

The purpose of this Agreement is to resolve contested matters in a manner consistent with the public interest. The contested matters were generated, in large measure, as a result of the Commission's Retail Electric Competition Rules and APS' regulatory filings made in response thereto. The parties recognize that the electric utility industry is undergoing a transition to competition, which is scheduled to begin on January 1, 1999.

It is the intention of the parties, APS and Commission Staff ("Staff"), through this Agreement, to provide resolution of the contested matters regarding APS' unbundled tariffs, APS' requested stranded cost recovery, and certain outstanding matters related to the Commission's Retail Electric Competition Rules. This settlement is intended to be comprehensive, fair to APS, its shareholders and customers and will serve to make an efficient and cost effective transition to a new era of customer choice in a competitive market structure. Therefore, the parties believe that this settlement is in the public interest.

The parties also agree that in exchange for APS divesting its Transmission Assets, as defined below, APS shall fully recover its stranded costs, as described herein. Under this Agreement, the basis for APS' opportunity to recover its stranded cost is the divestiture of APS' Transmission Assets including 345 kV and above. The failure of APS to divest of its Transmission Assets as provided herein will eliminate APS' opportunity to recover its stranded costs in the manner provided by this Agreement. Instead, the Commission may award transition revenues to APS in order to maintain its financial viability. For purposes of this Agreement, the term "divestiture" under the Commission's rules includes APS' divestiture of Transmission Assets as agreed to herein. Staff believes that APS' divestiture of these Transmission Assets limits the potential for APS to exercise vertical market power and as such constitutes a change in market structure in the transition to competition.

I. Contingency of Agreement.

This Agreement is contingent upon Commission approval of the Agreement in its entirety and without modification pursuant to a final and non-appealable order.

II. Unbundled Rates.

The Company's unbundled rates and charges will reflect (1) the embedded cost of service for all functions as approved by the Commission, (2) the 1.1 percent rate reduction approved by the Commission in Decision No. 61103 (August 28, 1998) and (3) separately identify distribution, transmission, metering, billing and system benefits and the remaining generation service, which shall consist of a Competition Transition Charge, ("CTC") a nonbypassable charge for Regulatory Assets, and a Market Generation Credit ("MGC"). Current recovery levels of Regulatory Assets will continue until all Regulatory Assets are recovered, at which point APS will, without further Commission action, adjust its prices to remove any charges for Regulatory Asset recovery, unless APS demonstrates and the Commission finds that APS has experienced offsetting increased revenue requirements attributable to Commission-regulated APS electric services.

The quarterly Market Generation Credits (MGC) shall be calculated for peak and off-peak hours for the next twelve months based on the Palo Verde Nymex futures price, plus 3 mills, and brought to the retail delivery level by multiplying by 1 plus the appropriate line loss. The peak and off peak prices shall be determined by shaping the Palo Verde Nymex futures price by actual hourly prices from the California spot price index. The adder will be adjusted for each class for differences between the class load factor and the system average load factor before being included in the MGC. The basic 3 mill adder shall remain in effect unchanged unless 25% of the load eligible for competition has not selected an alternative supplier by December 31, 2000, in which case the adder will be increased to 3.5 mills. By September 1, 2002, Staff and APS shall present to the Commission their recommendations regarding the appropriate Market Generation Credit for the period from January 1, 2003 until the CTC collection ends. At this same time, Staff and APS shall also present recommendations regarding the longer-term provision of Provider of Last Resort service. The monthly competitive transition charges shall be the residual after subtracting distribution, transmission, metering, billing, system benefits, the regulatory asset charge and the retail MGCs from the bundled tariff. The computation of the MGC and the CTC charge will be described in Exhibit A to this Agreement.

In addition, APS may file by September 1, 1999 an overall Company "revenue neutral" rate case to realign standard offer and unbundled rates in accordance with appropriate cost allocation and rate design principles. The Commission shall take such action as is necessary to rule on the Company's filing that redesigned, overall Company revenue neutral, rates will be effective as of January 1, 2001. This rate application will not change the Company's currently authorized cost of capital or request an overall revenue increase.

There may be a mismatch between the projected MGC and the MGC that would have resulted from the forward price at the close of each month for the following month. The

difference between these two forward prices for the same month multiplied by the competitive sale in a month shall be interpreted as an over or undercollection of stranded costs. Monthly under and overcollections shall be accumulated with a reasonable carrying charge. If the accumulated undercollection reaches \$5 million, the Company may increase the generation component of all rates by a factor that would collect these dollars within one year. At the end of the fixed rate period (end of 2002) or upon the cessation of the regulatory asset charge, if this occurs earlier, the Company shall increase or decrease generation rate charges to collect or return this amount during the remaining CTC period.

III. Recovery of Regulatory Assets.

APS will be allowed 100 percent recovery of regulatory assets in accordance with Section II. These will be identified separately in the unbundled tariffs.

IV. Transition Revenues/Stranded Costs

APS and Tucson Electric Power Company ("TEP") have executed the memorandum of understanding ("MOU"), attached hereto as Exhibit B, for the exchange of certain APS transmission assets, consisting of its 345 kV and 500kV facilities ("Transmission Assets"), for TEP's interests in the Four Corners Generating Plant and Navajo Generating Plant. The MOU commits both parties to negotiate in good faith to reach a definitive agreement on the exchange of assets. This MOU also outlines the structure of the transaction, describes the assets to be included in the exchange, establishes the Parties' good faith estimate of asset values, establishes a transmission pricing structure and lists the conditions to closing the transaction. These closing conditions include (1) securing independent appraisals and fairness opinions, and (2) obtaining all necessary consents and approvals from regulatory agencies and third parties in a form and substance satisfactory to both parties. This MOU is supported in its entirety by Commission Staff and approval of this Settlement Agreement by the Commission shall be deemed to constitute all requisite approvals necessary to consummate the transaction described in the MOU.

In the event that APS divests its transmission assets according to the MOU, APS will be allowed recovery of transition revenues through a CTC according to Section II of this Agreement until December 31, 2004. As part of this Agreement, the Commission will not alter the transition revenue amounts before December 31, 2004 unless the Commission finds that APS or its competitive affiliate has significant market power and has manipulated the market price for power in the region. This exceptions will allow the Commission to adjust, terminate or declare interim and subject to refund the transition revenue amount reflected in the CTC.

In the event that APS does not divest its transmission assets according to the MOU, except to the extent that any joint owner of any such assets exercises a right of first refusal, APS will not be allowed recovery of stranded costs through a CTC but rather interim transition

revenues will be implemented as identified in this Agreement. APS may file an application with the Commission to recover transition revenues based on its financial viability and actual load lost to unaffiliated electric service providers. It is anticipated that divestiture would occur in a transaction closing no later than December 31, 2000.

V. Divestiture.

Staff believes that achieving the following three objectives will limit the ability of APS to exercise vertical market power and will assist in achieving competition:

- (1) all network customers in an access area (or zone) should pay the same rate for transmission service.
- (2) all customers should have access to any generation within the region at no additional cost; and
- (3) transmission constraints and/or the allocation of Available Transmission Capacity ("ATC") should not be allowed to unduly frustrate competition.

These objectives can be met using either a region-wide "postage stamp" approach or a properly implemented "license plate" approach. If a "license plate" approach is to be used, it needs to be "all inclusive", i.e., all intra-regional transmission costs currently being paid by network customers within each access area need to be absorbed by the access area provider and reflected in the "license plate" rate. Under any pricing approach, congestion management and ATC determination will be crucial to a successful implementation. The following principles will apply :

- ← Subject to rights of first refusal which may be exercised by joint owners, APS shall transfer to TEP's affiliate ("Transco") all transmission facilities owned by APS at a voltage level of 345 kV and above. This is required for all components of the transmission system that may be subject to Committed Uses or constraints which, in turn, may be used to promote Vertical Market Power.
- ← APS shall file an application with FERC to place all facilities below the voltage level of 345 kV (which APS asserts serve a distribution function) under the jurisdiction of the ACC, with appropriate provisions for wholesale customers subject to FERC's jurisdiction.
- ← APS will work with the Transco to file comparable network and point-to-point tariffs, providing transmission service on a "license plate" basis over the combined APS/TEP service areas, and including adjacent systems as appropriate when the Independent Scheduling Administrator ("ISA") and/or Independent System Operator ("ISO") is implemented.
- ← APS will work with TEP to pursue the "license plate" approach and requisite filings even if the current ISA implementation plan fails to materialize or receive FERC approval as currently proposed.
- ← APS will work with TEP to ensure that all Committed Uses under their control will be used for all customers within their respective access areas on a non-discriminatory basis:

- ← APS will provide Staff with a comprehensive definition and explanation of all Committed Uses supported by APS (existing or contemplated).
 - If FERC rejects or otherwise orders APS to modify its commitments, APS will comply accordingly and will not seek to relieve itself of the obligations accepted herein.
 - APS will work with TEP to ensure that any and all Committed Uses are applied in a consistent manner for all transmission facilities so that no generation resources are given a competitive advantage by virtue of contractual constraints or protocols (as contemplated in the ISA filing) designed to limit ATC.
 - APS will pursue in good faith any mitigation measures (Re: The "license plate" approach) that are necessary for a full region-wide Desert Star (or other ISO) implementation without "pancaked" rates.
- ← APS shall on a regular basis, but not less than quarterly, provide Staff a written report and briefing on the activities described in this section. APS' failure to comply with the provisions of this section, other than the transfer of APS' transmission facilities as described herein, shall not, by itself, provide a basis for the Commission to modify any provision of this Agreement or of the order approving this Agreement, dealing with cost recovery.

VI. FERC Transmission Issues

APS and TEP will develop and present to FERC a transmission pricing structure for the use of such assets that will not increase rates to customers in APS or TEP's current service territories. APS will enter into a Service Agreement with TEP relating to APS' use of the Transmission Assets under an Open Access Transmission Tariff ("OATT") accepted by FERC. The OATT shall have zonal rates developed for the use of the transmission facilities pursuant to which the transmission rates for any transmission user in either APS' or TEP's current service territory, including APS' merchant group, shall not be adversely affected by the transfer of the Transmission Assets. Where APS transmission users are receiving service under a single agreement for both the Transmission Assets and the lower voltage transmission assets to be retained by APS, the Parties will agree to bifurcate those obligations in a manner that will not result in any cost shifting or increase in transmission costs to such users or APS. The Commission shall support the APS and TEP FERC filings to effectuate the transmission pricing principles described in this paragraph.

VII. Rate Reductions.

The existing Second Restated and Amended Rate Reduction Agreement, ("1996 Agreement"), as reflected in Decision No. 59601, will be extended until December 31, 2002, subject to the following revisions. In addition to the revisions listed below, the provisions of the 1996 Agreement that are or will be moot, extended with modifications or extended without

modifications are identified in Exhibit C hereto. Rate reductions for the years 1999 through 2002 will be:

For usage on and after July 1, 1999, 1.0% or the APS formula contained in the existing Second Restated and Amended Rate Reduction Agreement, as reflected in Decision No. 59601, using 1998 calendar year, whichever is greater, to be applied to both Standard Offer and unbundled rates;

For usage on and after July 1, 2000, 1.0% or the APS formula using 1999 calendar year, whichever is greater, to be applied to both Standard Offer and unbundled rates;

For usage on and after July 1, 2001, 1.0% or the APS formula using 2000 calendar year, whichever is greater, to be applied to Standard Offer rates for residential customers only;

For usage on and after July 1, 2002, 1.0% or the APS formula using 2001 calendar year, whichever is greater, to be applied to Standard Offer rates for residential customers only.

The impact of each year's rate reduction should be implemented through reductions to generation rates that result in equal percentage reductions to each class (including competitive customers).

Costs of complying with the Electric Competition Rules, system benefits costs, and solar power costs in excess of levels included in current rates, may be deferred subject to the limitations set forth below. Notwithstanding the rate reduction provisions stated above, the Company's share of any property tax expense decreases shall be used to offset other expense deferrals referred to in this section. In any year that the APS formula is used to calculate the rate reductions, ratepayer's 55% share above the stated, minimum 1% rate reduction, would first be used to reduce amounts otherwise deferrable. APS will be allowed full recovery of any remaining deferrable costs beginning January 1, 2003. APS agrees to make an annual reporting of its level of deferred expenses to be included in its rate reduction filings.

APS agrees to meet the requirements of the Solar Portfolio Standard, Section 1609 of the rules, as amended in August 1998. APS agrees to support the continuation of the Solar Portfolio Standard in future Commission proceedings. APS agrees to continue the programs included in the System Benefits Charge at a level equal to or greater than the level at which APS was funding those programs in 1997.

As applied to APS (as a utility distribution company), the solar portfolio standard ("SPS") established by the Commission for distribution companies in A.A.C. R14-2-1609(C), as amended in August, 1998, will be met by APS purchasing all the necessary solar power through an RFP process and recovering the associated costs through a "green" solar rate to market such solar power to its Standard Offer customers at a price designed to recover such costs (but, in the event revenue from such rate plus any additional revenue received from the sale of solar power to any other entities is not sufficient to fully recover such costs, any deficiency shall be deferred for recovery [including a reasonable return] as discussed above. The RFP process and cost recovery mechanism will be subject to (1) approval of the RFP by the Director of the Utilities Division by July 1, 1999, and (2) joint approval by APS and the Director of the Utilities Division of a successful, qualified responsive bid to such RFP.

VIII. Separation of Monopoly and Competitive Services

APS will transfer its generation services and competition assets at book value into a separate corporate affiliate no later than December 31, 2002. APS is also granted a waiver from compliance with the provisions of A.A.C. R14-2-1606(B) until December 31, 2002. Approval of this Agreement by the Commission shall be deemed to constitute all requisite Commission approvals for (1) the creation of a new corporate affiliate and the transfer thereto of APS' generation services and competitive assets at book value; and (2) the full and timely recovery through the mechanism referred to in Section VII above for the reasonable and prudent costs of such action. Such transfers may require various regulatory and third party approvals, consents or waivers from entities not subject to APS' control, including the FERC and the NRC. No party to this Settlement Agreement nor the Commission will oppose, or support opposition to, APS requests to obtain such approvals, consents or waivers.

By December 15, 1998, the Company will provide the ACC Staff with a detailed description of the process and the time necessary for a transfer of its generation and competitive service assets into a separate corporate affiliate. The Company shall also specify the nature and magnitude of any associated transaction costs that APS will request be recovered in rates.

By November 15, 1998, the Company will establish a separate energy services corporate affiliate (approval of which shall be deemed given by Commission approval of this Agreement) and will apply for a competitive CC&N to provide such competitive retail generation and other competitive services as it intends to offer. No later than November 30, 1998, the Company will file in the competitive CC&N docket a code of conduct that will address any and all concerns regarding the separation of monopoly and competitive services that arise from forming and operating a competitive affiliate while retaining generation assets until December 31, 2002. Staff will recommend to the Commission, by December 1, 1998, that it grant such application, subject only to such conditions as are reasonably imposed on other Energy Service Providers, unless specific circumstances warrant additional conditions.

IX. Independent Scheduling Administrator/Independent System Operator.

The Company shall commit to having an independent scheduling administrator ("ISA") in place and operational by April 1, 1999, and commit to facilitating the development of an independent system operator ("ISO") for Arizona by December 31, 2000. APS shall, on a regular basis, but not less than quarterly, provide Staff a written report and briefing on the status of the ISA and ISO. In the event APS does not have an independent scheduling administrator in place by December 31, 1998 or, an independent system operator by December 31, 2002, the Commission shall examine the reason(s) for the failure and the efforts expended by APS in compliance with this Section. APS' failure to comply with the provisions of this section shall not, by itself, provide a basis for the Commission to modify any provision of this Agreement or of the order approving this Agreement, dealing with cost recovery. The ISA/ISO also calculates available transmission capacity and implements protocols for system transfer capabilities, committed uses of the transmission system, must-run generating units (as

determined by the Commission) and provides dispute resolution such that market participants can expeditiously resolve dispute claims. If an Arizona only ISO is established, it is anticipated that it would join a regional ISO when one is established.

XI. Section 40-252 – Certificate of Convenience and Necessity

APS agrees to modify its Certificate(s) of Convenience and Necessity to permit competition pursuant to A.A.C. R14-2-1600, et seq., as amended in August 1998. The order adopting this Settlement Agreement shall constitute the necessary Commission Order modifying APS' CC&Ns to permit competition.

XII. Resolution of Litigation.

Upon issuance by the Commission of a final, non-appealable order approving this Agreement, APS shall move to dismiss with prejudice all pending litigation brought by APS against the Commission. As mutually agreed, APS will actively support the Commission's position and assist the Commission in any remaining litigation regarding the Commission's Electric Competition Rules or related matters.

XIII. Must Run Assets.

To the extent such contracts are not subject to FERC jurisdiction, contracts regarding the sale of output from must run generation units shall be reviewed and approved by the Commission.

XIV. Waivers.

APS has requested waiver of certain Affiliated Interest Rules. Staff concurs with APS' requests for waivers of certain Affiliated Interest Rules, and agrees that the Commission's approval of this Agreement will constitute the Commission's granting of the waivers, under the following conditions and limitations:•

R14-2-801(5)

APS has requested a waiver of the definition of "reorganization" to exclude corporate reorganizations that do not involve a reconfiguration of the utility distribution company ("UDC") in the holding company structure. Under the waiver proposed by APS, the holding company would be free to reorganize, buy or sell non-regulated affiliates without Commission approval. Staff agrees that R14-2-801(5) is waived as applied to APS' non-regulated affiliates to the extent that the UDC is not implicated in any reorganization of the holding company's structure or the non-regulated affiliates' structure. In any reorganization where the UDC is implicated in any manner as to reconfiguration of the holding company's structure or an affiliates' reconfiguration, or if the UDC forms, divests

or reconfigures any of its subsidiaries. Rule R14-2-801(5) is not waived and is applicable to APS (UDC).

R14-2-804(A)

APS has requested a waiver of the rule that requires any affiliate that transacts business with the UDC to open its books and records to Commission review. Staff agrees that R14-2-804(A) may be waived as long as the non-regulated affiliate's books and records reflect transactions with the UDC and are included in the Code of Conduct required by the Electric Competition Rules. By this waiver, the Commission still retains jurisdiction to review and have access to the books and records of affiliates of the UDC for whatever purposes the Commission deems appropriate if the Commission's rate setting jurisdiction is implicated.

R14-2-805(A)

APS has requested waiver of the rule that requires a holding company to file an annual report with respect to diversification plans and the activities of unregulated subsidiaries. The affect of the waiver requested by APS would be to limit the annual filing requirement to the UDC only. Staff agrees that the annual filing under the rule can be limited to the UDC unless the holding company or subsidiary's activities implicate the UDC, and have a likely material adverse affect upon the UDC's financial viability and integrity.

R14-2-805(A)(2)

This Rule requires a specific description of business activities of all affiliates to be filed with the Commission on an annual basis. APS wishes to have a waiver of the Rule and limit disclosure to the nature of the business rather than specific activities. Staff agrees this Rule may be waived to the extent indicated by APS.

R14-2-805(A)(6)

APS seeks a waiver of the disclosure requirement in the annual filing for bases for allocation of all plant revenue expenses to all regulated and unregulated entities in the holding company structure. APS' request limits disclosure to allocations applicable to the UDC. Staff agrees with this waiver to disclosure but reserves the Commission's jurisdiction to receive disclosure of the bases for allocation if necessary in the Commission's determinations in any matter, including but not limited to rate setting matters.

APS seeks a waiver of the annual submission of contracts and agreements for transactions between the regulated utility and nonregulated affiliate. Staff agrees to the waiver of this requirement as requested by APS as to the contracts and agreements which are not covered by the Code of Conduct required by the Retail Competition Rules or not subject to FERC approval. However, the Commission reserves the jurisdiction to receive the information that would have been submitted under the rule, if the Commission deems necessary for any purpose including, but not limited to rate setting matters.

XVI. Implementation of Retail Access.

Direct access to electric generation suppliers will be phased in for all customers in APS' territory in accordance with A.A.C. R14-2-1604. APS shall determine residential customers eligible for retail access pursuant to the plan filed by APS with the Commission on September 15, 1998. For customers that are 20 kW or smaller at each premise, load profiling will be allowed.

XVII. Clarification of Services that Must and Can be Offered by APS

Staff will support amending A.A.C. R14-2-1616.B, as provided in Exhibit D hereto.

XVIII. Consideration for Agreement

The Company's willingness to enter into this Agreement and to withdraw from certain civil actions against the Commission is based upon the Commission's irrevocable promise herein to permit recovery of the Company's regulatory assets and stranded costs as provided herein. Such promise by the Commission shall survive the expiration of the Agreement and shall be specifically enforceable against this and any future Commission.

MISCELLANEOUS PROVISIONS

1. Admissions.

This Agreement represents an attempt to compromise and settle disputed claims arising out of APS' Applications in a manner consistent with the public interest. Nothing contained in this Agreement is an admission by any of the parties that any of the positions taken, or that might be taken by each in formal proceedings, is unreasonable. In addition, acceptance of this Agreement by the parties is without prejudice to any position taken by any party in these proceedings.

2. **Commission Action.**

Each provision of this Agreement is in consideration and support of all the other provisions, and expressly conditioned upon acceptance by the Commission without change. In the event that the Commission fails to adopt this Agreement according to its terms by November 25, 1998, this Agreement shall be deemed withdrawn and the parties shall be free to pursue their respective positions in these proceedings without prejudice.

3. **Limitations.**

The terms and provisions of this Agreement apply solely to and are binding only in the context of the provisions and results of this Agreement and none of the positions taken herein by the parties may be referred to, cited or relied upon by any other party in any fashion as precedent or otherwise in any other proceeding before this Commission or any other regulatory agency or before any court of law for any purpose except in furtherance of the purposes and results of this Agreement.

4. To the extent that any provisions of this Agreement are inconsistent with the Commission's Electric Competition Rules, the provisions of this Settlement Agreement are intended to apply. However, no waivers of any Commission rules are granted to APS except as provided herein.

5. **Low Income Customer Programs.**

Prior to Commission consideration of this Settlement Agreement, the parties acknowledge that APS may enter into discussions with others regarding low income customer programs and, as a result, may request Commission recognition of the results of such discussions.

6. **Proposed Order.**

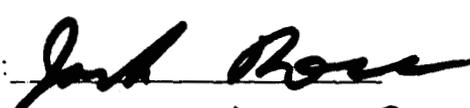
The proposed form of order acceptable to the parties is contained in Exhibit E, attached hereto.

Dated this Nov 4, 1998

Arizona Public Service Company

Arizona Corporation Commission

By: 

By: 

Title: CEO

Title: Executive Secretary

Calculation of the Market Generation Credit

The Market Generation Credit ("MGC") will be stated as an Off-Peak and an On-Peak value for each calendar month. For all customers less than 1MW in size, the total monthly dollar credit will be calculated by customer class and will use the same energy consumption profile for each customer within a particular class. The total monthly dollar credit for customers 1 MW or greater will be calculated individually for each customer. All MGC values will be determined in the month of November for the succeeding calendar year. The calculations will be based on the NYMEX forward price curve for the succeeding calendar year and the historical California PX Prices for the preceding year. The MGC values will be grossed up by the distribution Loss Factor as well as the Adder, as such terms are defined below.

$$\text{On-Peak MGC} = [(\text{NYMEX}) * (1 + \text{Loss Factor})] + \text{Adder}$$

$$\text{Off-Peak MGC} = [(\text{NYMEX}) * (1 + \text{Loss Factor}) * (\text{LLR})] + \text{Adder}$$

Where:

- Adder:** An addendum to the calculated prices designed to promote competition and credit customers for ancillary services. This adder will be set at 0.300 ¢/kWh for conforming loads (those with coincident peak load factors equivalent to the aggregate system load factor). This adder will be adjusted by the ratio of system load factor to customer load factor and stated in increments of 5 between 35 percent and 95 percent load factors.
- Loss Factor:** A multiplier designed to reflect the appropriate distribution losses by voltage level.
- LLR:** A light load ratio calculated by dividing the average California Off-peak price by the average California On-Peak prices for the same month of the preceding year. The California Off-Peak and On-Peak prices will be the hourly day-ahead unconstrained California PX prices.
- Off-Peak:** All holidays and hours recognized by the Western Systems Coordinating Council as off-peak periods.
- On Peak:** All non-Off Peak hours.
- NYMEX:** The Palo Verde electricity futures contract traded on the New York Mercantile Exchange for each month of the following calendar year as determined in November of the preceding year.

Monthly Customer Transition Charge Calculation

The monthly Customer Transition Charge (CTC) will be calculated using the following formula:

$$CTC = [(\text{Tariff Generation Charges}) * (\text{Billing Determinants})] - [(\text{MGC} + \text{Adder}) * (\text{Billing Determinants})]$$

The monthly CTC cannot be less than zero.

True-Up of the Monthly Customer Transition Charge Calculation:

The difference between the projected monthly NYMEX price as described above and the actual NYMEX price as determined by the average of the last three trading days for that month will be multiplied by that month's competitive direct access sales. This monthly amount will be considered an over- or under-recovery of stranded costs. These differences will then be accumulated (including a return component), and at the end of each calendar year will be divided by the next calendar year's projected competitive direct access sales. The resultant factor (in ¢/kWh) will be applied to any competitive direct access sales during the following calendar year in order to adjust the CTC for the calculated true-up.