ORIGINAL

BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR AUTHORIZATION FOR THE PURCHASE OF GENERATING ASSETS FROM SOUTHERN CALIFORNIA EDISON AND FOR AN ACCOUNTING ORDER.

Docket No. E-01345A-10-0474

RUCO'S OPENING BRIEF

The Residential Utility Consumer Office ("RUCO") submits its Opening Brief in APS' ("APS" or the "Company") application for authorization to purchase the generating assets from Southern California Edison ("SCE") and for an accounting order.

SUMMARY

RUCO supports APS' request to purchase SCE's 48% interest in Four Corners Units 4 and 5, to retire Units 1, 2, and 3, and to receive an accounting order to defer these associated costs subject to certain conditions—most notably that APS not be allowed to earn a return on the deferral costs. RUCO finds APS' request to be in the best interest of ratepayers and provides numerous economic and environmental benefits. Finally, RUCO finds an RFP is not required under Commission Rule.

INTRODUCTION

APS' proposal to purchase the 48% ownership interest of SCE in Units 4 and 5 of the Four Corners Generating Plant is in the public interest. Faced with the prospect of a very expensive retrofit to old and outdated plant (Units 1, 2 and 3), APS has presented an alternative that would replace that generation and add some at a rock-bottom price that would not only benefit the ratepayers and APS' shareholders but would reduce emissions and help to sustain the economy of the Navajo Nation. This proposal offers both economic and environmental benefits. Overall, APS' proposal is a winner which RUCO finds to be in the best interest of ratepayers and recommends that the Commission approve the Application.

APS also recommends the Commission grant an accounting order authorizing APS to defer and capitalize for future recovery all non-fuel costs associated with owning and operating its acquired interest in Units 4 and 5 and providing assurance that APS will fully recover its investment in Units 1, 2 and 3.[1] RUCO supports the approval of an accounting order subject to certain conditions. As will be explained more fully below, APS has agreed to the majority of the conditions. The remaining dispute is RUCO and Staff's recommendation that APS not be authorized to earn a return on any of the deferrals. APS-15 at 9.

1) APS' proposal is in the public interest.

The Four Corner's plant serves customers in Arizona, California, New Mexico, and Texas. RUCO-1 at 4. Units 1- 3 are the smallest of the five Units and have a combined output of 560 MW. Units 4 and 5 each provide 770 MW of electricity. SCE owns 48% of Units 4 and 5, for a total of 739 MW and APS owns 15% for a total of 231 MW. Id. The other owners of

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[1] For ease of reference, trial exhibits will be identified similar by their identification in the Transcript of Proceedings. The transcript volume number will identify references to the transcript.

Units 4 and 5 include the Public Service Company of New Mexico (14%), Salt River Project (10%), El Paso Electric Company (7%) and Tucson Electric Power (7%). Id. APS operates the plants on behalf of all participants and APS' current total ownership interest in Four Corners provides 791 MW. Id. If the Commission approves APS' request to shut down Units 1, 2, and 3 and acquire SCE's interest in Units 4 and 5, APS' new ownership interest in Four Corners would provide 970 MW, a net increase of 179 MW over its present total. Id. at 4-5.

APS' application is not a coincidence. In short, SCE decided to cease its participation in Four Corners for compliance reasons associated with the introduction of rules established by California Public Utilities Commission. Id. at 5. The co-owners of Four Corners were faced with a choice. If no one picked up SCE's share, the co-owners would be faced with closing the Units rather than assume the risk of a multimillion dollar expenditure for which there would be no subsequent recovery. Application at 3. APS considered several alternatives and determined the best solution would be to retire Units 1, 2 and 3 and acquire SCE's share of Units 4 and 5.

2) APS considered three alternatives and its proposal is the least expensive, and provides ratepayers with the most benefit.

In total, APS considered three alternatives. The first alternative is the present proposal. The capital cost for alternative 1 is $533.6 million, or $722,100 per MW. RUCO-1 at 10. The second alternative would require APS to continue operating Units 1, 2, and 3 and pay the cost of the proposed environmental regulations affecting those Units. The capital cost of alternative 2 is $486.4 million, or $1,047,100 per MW. Id. The third alternative would be to replace any power lost from Four Corners with newly constructed APS owned combined-cycle gas generation located in the Palo Verde area. The capital cost of this alternative is $865.7 million, or $1,472,300 per MW. Id. at 10-11.

According to APS, of the three alternatives, the Company's proposal (alternative 1) is optimal for the following reasons:

• It saves APS customers money, providing them a nearly $500 million net present value benefit. APS estimated that the cost of purchasing SCE's share of and installing the EPA-proposed environmental upgrades on Units 4 and 5 is half of what it would cost APS to replace its Four Corners output with natural gas generation and build the transmission needed to bring that power to customers.

• It has a lower customer bill impact than that of every other alternative.

• It saves hundreds of jobs and millions of dollars of revenue that are critical to the Navajo Nation and the local economy.

• Since Units 4 and 5 will not be retired until 2038, it provides APS with more options for construction of suitable baseload generating plant.

• It significantly reduces Four Corners' carbon dioxide and other pollutant emissions by retiring three less efficient coal units and installing environmental upgrades on more efficient ones.

• It preserves the diversity of APS' current generation portfolio while tempering the Company's exposure to volatile natural gas prices.

• It maintains APS' mix of reliable baseload energy. By providing a marginal 179 MW baseload capacity increase, it hedges the Company's energy mix against the possibility that output from other coal units also at risk could be retired and helps further defer the need for future baseload resources. Id. at 11-12.

RUCO's independent analysis of the proposed transaction and the other alternatives considered results in findings and conclusions consistent with those of APS. In fact, from RUCO's review "... no one could reasonably envision situations where the Company's requested alternative is not the best." Id. at 14. The parameters used in the models used by APS to determine the optimal alternative would have to change in some unforeseen and extreme manner in order for the model solution to change. Id. RUCO concurs that APS' proposal is optimal and a very good deal for ratepayers.

3) A delay in the closing date is in the ratepayers best interests.

The proposed transaction is scheduled to close on October 1, 2012. Id. at 16-17, Application at 97. The contract between APS and SCE provides for a $7.5 million reduction of the purchase price for each month the closing is delayed. Delaying the closing would be beneficial for several reasons. First, delaying the closing would mitigate the size of the corresponding rate increase without hurting the Company from a regulatory standpoint. Id. at 19. Second, the transaction provides for an additional 179 MW of baseload generation over the amount of current generation and APS has not claimed there is a compelling immediate need for the additional generation. Third, the $7.5 million is money that APS does not have to pay. Transcript at 617. Finally, SCE would have the additional benefit of the baseload generation for the period of the delay. Id.

APS has raised some concern that failing to close on the closing date will jeopardize the deal. RUCO, however, remains unconvinced. Transcript at 617-618. The parties are sophisticated utilities and adept at contract negotiation. Id. There is a reason this provision is in the contract – it is not mere coincidence. Id. at 632. Clearly, this provision was made a part of the Agreement in anticipation of at least some delay. Id. Under the circumstances of this case, delay in the closing works to the ratepayer's benefits and does not harm the Company.

APS has also expressed concern that RUCO's proposal to delay the closing date would result in an insufficient amount of time to install the environmental remediation measures required by the new EPA regulations. This is not RUCO's intention. The new EPA regulations are expected to be promulgated soon and will require all coal generators to install a retinue of environmental controls in the near future. APS-11 at 4. SCE announced that it will terminate its ownership in Four Corners by 2016 due to California's emissions performance standard which SCE was unable to get a waiver. S-2 at 17. RUCO understands that it will take a reasonable amount of time to install the needed upgrades. RUCO contends that the closing date should be set at the latest possible date that still provides APS and the other stakeholders enough time to comply with the new EPA mandate. Such delay saves APS ratepayers money and does not injure the interests of APS, SCE or the other stakeholders.

4) The Company's proposal should not be delayed by an RFP process.

Just two parties have either opposed APS' proposal or requested that APS be ordered to conduct an RFP. SC-2 at 4, Patterson D at 13. These parties believe that natural gas may be a better alternative than coal, and that further analysis is appropriate to ascertain the best alternative. In general, RUCO believes the public is better served by a thorough review of all options. However, RUCO believes there is a difference between a complete review of relevant evidence and speculative guessing. Based on testimony in this proceeding, there is no evidence that a long-term natural gas contract in substitution for Four Corners generation would be less expensive. Transcript at 1016. Furthermore, evidence in the record shows that APS has gone out to the market to acquire replacement long-term natural gas contracts to replace expiring ones without much success. APS-8 at 12-13. Moreover, RUCO has significant concerns with an electric utility having to rely on a third party to provide such a large amount of generation to meet its baseload obligations.

Arizona's ratepayers have a real opportunity to capitalize on a situation that has arisen because of a change of the law in California – California's loss can be Arizona's gain. This is a great opportunity for Arizona's ratepayers to acquire generation at a rock-bottom price and save money - the net present value of the potential ratepayer benefit is estimated to be $500 million. RUCO-1 at 11. Moreover, among its many other benefits, approval of APS' recommendation will expand APS' baseload generation capacity while reducing emissions, and will continue to provide stability to the Navajo Nation's economy and be the Nation's major employer Id. at 29.

Delaying a decision on this matter for the purpose of issuing an RFP will likely jeopardize the deal. Transcript at 872, APS-13 at 10. Even the opponents of APS' proposal acknowledge that if the Commission chooses an alternative to APS' recommendation, there would be a "dramatically negative" effect on the Navajo tribe. Transcript at 970-971. Moreover, when asked about the likelihood that an RFP process will result in a better alternative than what APS' proposes, at least one opponent simply did not know. Transcript at 996-997. There is no other evidence in the record which concludes that an RFP process would result in a better outcome for the ratepayers. Even Mr. Patterson acknowledged "On cost, nobody competes with a fully depreciated coal plant..." Transcript at 1016.

In sum, an RFP process or a delay for the purpose of considering a natural gas alternative is risky, with no evidence that it is likely to lead to a better alternative. If the Commission were to approve another alternative which ultimately leads to a bad result, then it is the ratepayer as well as the Navajo Nation that loses. To add further insult to injury, if the deal falls through and there ultimately is not a better alternative, not only will the Navajo Nation suffer dramatically and ratepayers miss out on a golden opportunity, ratepayers will ultimately have to pay higher rates to cover the higher costs associated with the selected alternative.

It should also be noted that parties like the Arizona Competitive Alliance, who are requesting the RFP process, have a vested interest in the RFP process. Transcript at 975. The Alliance members are the ones likely to be responding to the RFP, and only stand to benefit should APS' proposal fall through. Ratepayers should not have to forfeit a golden opportunity on the off-chance that an RFP proposal could result in a better alternative.

5) APS is not required to do an RFP.

As a preliminary matter, RUCO agrees with Staff that APS needs to obtain Commission authorization to acquire SCE's share of Four Corner's Units 4-5. S-2 at 2. The modified Settlement Agreement approved by the Commission in Decision No. 67744 (April 7, 2005), prohibits APS from pursuing any self-build option without express Commission approval. The term "self-build" includes the acquisition of a generating unit or interest. Decision No. 67744 at paragraph 33, S-2 at 2.

A.A.C. R14-2-705 (B) governs the applicable procurement methods. It provides in relevant part "[a] load-serving entity shall use an RFP process as its primary acquisition process for the wholesale acquisition of energy and capacity," unless subject to exception. S-2 at 15. The relevant exception, A.A.C. R- 14-2-705(B)(5) allows a utility to use a procurement method other than an RFP if "the transaction presents the load-serving entity a genuine, *unanticipated* opportunity to acquire a power supply resource at a clear and significant discount, compared to the cost of acquiring new generating facilities, and will provide unique value to the load-serving entity's customers." Id.

APS believes that this "transaction presents the load-serving entity a genuine, unanticipated opportunity to acquire a power supply resource at a clear and significant discount, compared to the cost of acquiring new generating facilities, and will provide unique value to the load-serving entity's customers" according to A.A.C. R14-2-705(B)(5). Id. The evidence supports APS' interpretation.

SCE advised the other owners of Four Corners in 2010 that it would no longer make "life-extending" capital investments in Four Corners and would divest its interest by 2016. Id.at 16. SCE's reason for its divestiture was its inability to meet changes in California's emission performance standards dating back to 2006. Id. at 17. SCE attempted to get a waiver of the standards as applied to Four Corners but the California PUC denied its request in Decision No. 10-10-016, issued on October 14, 2010. Id. at 17.

Staff makes the case that APS' proposal is a genuine, unanticipated opportunity since it was unknown until the California PUC decision in October 2010 rejecting SCE's waiver request, the extent to which SCE would be allowed under California law to make continued investments in Units 4 and 5. Id. The Arizona Investment Council ("AIC") believes that the turn of events was anticipated since APS' Mohave plant closed in 2005. Transcript at 949-950. AIC argues that coal has been "going out of style for several years now" and Four Corners, like Navajo and Mohave are the same generation (coal) plants. Transcript at 979. In addition, according to AIC, the California law changed in 2006 so there is an understanding that as of 2006 California utilities were not going to be "...participating in coal plants anymore." Id.

AIC makes a good point but the argument is not persuasive. It follows from AIC's argument, that any closure of a California based coal plant after 2005 is an anticipated event due to the Mohave closure and the change in the law in 2006. The change in the law, however, dealt with emission standards. It did not ban California utilities from coal generation. There were emission standards before the laws changed in 2006 – the Mohave closure took place prior to the 2006 changes. Moreover, there is no evidence in the record that every

California utility that utilizes coal generation has shut down or intends to shut down because of the Mohave closure or the change in the law.

Staff is correct. No one, not even SCE, knew what SCE's circumstances were regarding additional capital expenditures until after the California PUC denied SCE's waiver application in 2010. In the absence of evidence to the contrary, the evidence in this record supports Staff's conclusion that the event that gave rise to SCE's decision was unanticipated.

The second part of the exception requires that the purchase of the power source be made at a clear and significant discount. Staff addresses this point also and concludes:

> When these alternatives are compared on a dollars per kW basis, the proposed transaction, at $847/kW, comes at a significantly lower cost than the other two alternatives. Moreover, over the life of the investment, the costs of the proposed transaction, at $85/MWh, are lower than the costs associated with the other alternatives.

S-2 at 20. Although Staff's numerical conclusions of cost are somewhat different than APS' citied above – the conclusion is the same – APS' proposal comes at a clear and significant discount to ratepayers.

The final consideration of the RFP exception is whether the proposed transaction proves unique value to the customer. Staff and APS conclude that the transaction provides unique value:

> In comparing the three alternatives, over the life of the investment, the proposed transaction results in a system-wide revenue requirement that has a net present value that is $488 million less than the next least-expensive alternative of replacing 791 MW with combined-cycle natural gas generation and $1.08 billion less than the alternative of investing in environmental upgrades for Four Corners Units 1-3.

S-2 at 20, APS-8 at 7.

There is also value to APS' customers, from a societal sense, in helping to maintain the Navajo Nation's economy. This value is truly unique in that the Navajo Nation covers more than just Arizona and the plant is a major employer of the Navajo Nation. Even the AIC agrees that closing the plant would have a dramatic effect on the Navajo Nation. Transcript at 970-971.

In sum, APS is not required to issue an RFP since the event that triggered APS' proposal was genuine and unanticipated, the proposed transaction would be at a deep discount, and there is clearly unique value to the customers. Moreover, to require APS to go through an RFP process would place the transaction in jeopardy which is not in the public interest.

6) In addition to economic benefits, APS' Four Corners proposal yields environmental benefits.

a) Retiring Units 1-3, and installing emission controls on Units 4 and 5 will result in dramatic declines in air emissions and water consumption. WRA-1 at 3. Carbon dioxide emissions would decline between 19% and 34%, sulfur dioxide emissions would decline by approximately 25%, nitrogen oxide emissions would decline by approximately 88%, mercury emissions would decline by at least 61% and water consumption would decline between 18% and 30%. Id.

b) The reduction in emissions will result in improved visibility, reduced health impacts and reduced emissions of greenhouse gases. Id. at 12.

c) APS still has a well-balanced, diverse portfolio of fuels.

d) Eliminates public policy concerns over hydro-tracking that would come with increased reliance on natural gas.

7) The Commission should grant APS an accounting order subject to RUCO's proposed conditions.

APS has requested an accounting order which, among other things, will authorize APS to defer its costs and facilitate the early retirement of Units 1-3. Application at 28. RUCO does not object to an accounting order. However, RUCO requests that the accounting order be subject to the same conditions placed on the accounting order in the Company's Sundance case (Docket No. E-01345A-04-0407, Decision No. 67504):

> "No deferrals shall be recorded unless its PSA continues to recognize off-system sales as a credit (reduction) to the recoverable balance." (p. 26)
>
> "The deferral period shall stop if off-system sales are no longer recognized as a credit." (p. 26)
>
> "Debits to the deferred costs shall terminate no later than 36 months after the completion of the transaction or on the effective date of rates authorized in any rate case subsequent to the transaction." (p. 27)
>
> "No cost of money shall be applied to any deferred amounts." (p. 27)
>
> "Overhead costs shall not be deferred." (p. 31)
>
> "Deferred direct costs shall only be debited when supported by an analysis conducted by the Company demonstrating that those costs have not been otherwise recovered." (p. 31)
>
> "Projections may be used to calculate the net savings components (fuel costs, purchased power and off-system sales) of deferred costs. The projections shall have identical parameters, 1 except to recognize the inclusion of the Sundance Generating Station, to eliminate bias and manipulation and to facilitate accurate measurement of net savings." (p. 35)
>
> "The results of the projections shall be reported as part of the monthly filings required for the PSA." (p. 36)
>
> "APS shall participate in the net savings/costs related to fuel and purchased power costs and off-system sales at the same percentage rate as it participates in the PSA." (p. 36)

RUCO-1 at 32-33. For the most part, the Company would agree with the applicable and relevant conditions listed above with the exception of the condition which denies the company the "cost of money" applied to any deferred amounts.[2] Transcript at 720-729. If the Commission were to consider an accounting order, Staff also recommends certain conditions apply. As with the case of RUCO, the Company's primary objection to Staff's conditions concerns "APS' request to apply cost of money, i.e., return, to any deferred amounts." Transcript at 732.

The dispute, for all intent and purposes, centers on the Company's request to earn a return on the deferred accounts. In this case, the Company is requesting that it earn a return equal to its pre-tax embedded weighted cost of capital from its last rate case of 12.21%. RUCO-1 at 31. RUCO believes it would be inappropriate to allow the Company to earn a return – in effect, such an allowance would simply be guaranteeing the Company a return rather than providing it with an opportunity to recover that return via its operating efficiency. Id. at 31. Staff sees it similarly - applying a carrying charge infers that the qualitative and quantatative factors that normally go into determining the charge can be identified and refined to a high degree, which is not the case. S-3 at 10. Staff concludes that such a determination goes beyond the balance of interests between the Company and ratepayers and "leans more toward providing a guarantee." Id. A deferral authorization allows the Company an opportunity to recover costs that it ordinarily may not be entitled to recover, and applying a carrying cost to that deferral is not appropriate. Id. The Commission should reject the Company's request to earn a return on the deferral amounts.

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[2] For example, APS claims that some of the conditions are unclear in application such as the condition concerning the deferral of direct costs, or inapplicable like the use of projections to calculate the net savings component of the deferred costs. Transcript at 727-728.

CONCLUSION

APS' request to purchase SCE's 48% ownership interest in Units 4 and 5 of the Four Corners generating Plant should be approved. Likewise, APS' request to retire Units 1, 2 and 3 concurrent with the purchase of SCE's interest should also be approved. The transaction will result in numerous benefits to the ratepayers, will help continue to sustain the Navajo Nation economically, and is clearly in the public interest.

If it is possible to delay the closing and not jeopardize the transaction, RUCO recommends that the transaction be delayed. Each month it is delayed results in a $7.5 million reduction in the purchase price, which translates to a smaller future rate increase.

The Commission's Rules do not require APS to issue an RFP to acquire SCE's 48% interest. Finally, the Commission should approve APS' request for an accounting order subject to the conditions RUCO has recommended.

RESPECTFULLY SUBMITTED this 30th day of September, 2011.

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