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**BEFORE THE ARIZONA CORPORATION COMMISSION**

COMMISSIONERS

10 GARY PIERCE, Chairman  
 11 BOB STUMP  
 12 SANDRA D. KENNEDY  
 PAUL NEWMAN  
 BRENDA BURNS

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

DOCKET NO. E-01345A-10-0474

Arizona Corporation Commission

**DOCKETED**

OCT 14 2011

DOCKETED BY

21 **REPLY BRIEF**  
 22 **OF**  
 23 **ARIZONA PUBLIC SERVICE COMPANY**

October 14, 2011

28

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1 **I. INTRODUCTION**

2 The week that Arizona Public Service Company (“APS” or “Company”) announced  
3 its plan to buy Southern California Edison’s (“SCE”) share of Four Corners Units 4 and 5  
4 and close down Units 1-3, the *Arizona Republic* ran an editorial entitled “APS Coal-Plant  
5 Plan Benefits All.”<sup>1</sup> That article equated the APS plan with Alexander the Great’s outside-  
6 the-box approach to dissolving the “Gordian knot” of Greek lore – not by untying it as  
7 others had tried for years but failed to do, but by shearing it in two with his sword. The  
8 newspaper wrote:

9 APS was facing prohibitively expensive requirements to clean up one  
10 of the dirtiest generating stations in the nation, the coal-fired Four  
11 Corners Power Plant. The usual long, costly battle among a utility,  
12 regulators, and environmentalists was looming. Instead, APS sliced  
13 through the complex issues and came up with a creative solution:  
14 Close the dirtiest part of the plant and expand its ownership stake in  
15 the newer, cleaner units. . . . With one ingenious stroke, APS has  
16 found a way to benefit customers, the environment, the Navajo  
17 Nation and its own long-term corporate interests.

18 *Id.*

19 The days of hearing, pages of testimony and briefing in this case proved out  
20 precisely what the *Arizona Republic* described. Indeed, Commission Staff, RUCO, Western  
21 Resource Advocates (“WRA”) and the Environmental Defense Fund (“EDF”) have  
22 repeatedly affirmed their support for the proposed transaction precisely because of the  
23 broad public interests it serves. As the post-hearing briefs make clear, each of these parties  
24 agrees that the APS plan is consistent with and should be authorized under the terms of the  
25 “self-build moratorium” contained in Decision No. 67744. Each of these parties agrees that  
26 the circumstances underlying the proposed transaction warrant an accounting order that  
27 would allow the transaction to move forward (though there is some disagreement on what  
28 such an accounting order would allow). And none of these parties believe that APS should  
be forced to issue an RFP for a competing resource, or that any rule, law, or policy would  
require such a solicitation.

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<sup>1</sup> See Application at Attachment A.

1           Only two parties argue that the transaction should not be authorized, and each of  
2 them has a lot to gain if it is not. The Sierra Club, though exclaiming its primary focus is  
3 economics, is really an advocate against coal-fired generation that has specifically targeted  
4 Four Corners for closure. And the Arizona Competitive Power Alliance (“ACPA”)  
5 represents merchant generators – businesses that profit from selling wholesale power  
6 generation (primarily natural gas) to APS and others. By taking internally inconsistent  
7 positions, mischaracterizing the record, and offering only a series of sound bites that lack  
8 any evidentiary support, the ACPA and Sierra Club have demonstrated a willingness to  
9 ignore the evidence and undermine the common good to serve their respective self-interests.  
10 Their flawed arguments and analyses do not stand.

11           Only one real dispute remains: the breadth of the requested accounting order.  
12 Although Commission Staff and RUCO recognize that the present circumstances warrant  
13 the Company’s requested accounting order, they would dramatically limit the allowed  
14 deferral such that it would address less than half of the mismatch between costs and benefits  
15 that result if the transaction is consummated, requiring APS to take a multi-million dollar  
16 revenue hit. Their position that APS should not even be allowed to include financing costs  
17 as part of the deferred balance (as opposed to applying a cost of money to a deferred  
18 balance that includes financing costs) arbitrarily defies all known precedent in and out of  
19 Arizona without any justification. As a practical matter, so limiting the deferral will  
20 increase the risk that the proposed transaction will not be consummated and its universally-  
21 recognized benefits lost.

22 **II. NEITHER RULE NOR POLICY REQUIRES APS TO ISSUE AN RFP IN**  
23 **THIS INSTANCE.**

24           In its Initial Post-Hearing Brief, APS explained that neither Decision No. 67744 nor  
25 the Commission’s Resource Planning rules require APS to issue an RFP for whatever  
26 resource might be needed if the proposed transaction is not consummated, and that ACPA  
27 introduced only anecdotal conjecture to rebut the clear evidence in the record highlighting  
28 the economic value of the APS plan compared to a natural gas alternative. *See* APS Initial

1 Post-Hearing Brief at 15-25, 40-42. Staff agrees with APS, aptly noting that “while ACPA  
2 criticizes APS for failing to conduct an RFP, ACPA has failed to introduce any evidence  
3 whatsoever as to the value of any bids APS might expect were it to issue an RFP. In this  
4 regard, ACPA has failed to rebut the evidence proffered by APS.” Staff’s Closing Brief at  
5 4. RUCO shares this sentiment, concluding that “an RFP process or delay for the purpose  
6 of considering a natural gas alternative is risky, with no evidence that it is likely to lead to a  
7 better alternative.” RUCO’s Opening Brief at 7. WRA and EDF are in accord, noting that  
8 “a competitive solicitation would be unlikely to result in a lower cost option than APS’s  
9 proposal under a range of reasonable assumptions.” Post-Hearing Brief of WRA and EDF  
10 at 6.

11 In its Post-Hearing Brief, the ACPA mounts a lengthy legal argument in attempt to  
12 demonstrate that APS was required to issue an RFP for a resource alternative to the Four  
13 Corners deal before it could seek authorization to proceed with the proposed transaction.  
14 But there are three fatal problems with this position: (1) the ACPA’s legal interpretation of  
15 Decision No. 67744 ignores the express language of that Decision; (2) the resource need  
16 that the APS plan seeks to fill is far narrower than the ACPA would suggest; and (3) the  
17 ACPA too narrowly construes the nature of the resource “opportunity” underlying the  
18 proposed transaction.

19 To the first point, contrary to the ACPA view, the language of the “self-build”  
20 provisions of Decision No. 67744 does not require APS to undergo any competitive  
21 solicitation prior to seeking the Commission’s authorization of a desired acquisition.  
22 Rather, in any request for authorization to self-build generation, the agreement requires  
23 APS to “address” a series of items so as to inform the Commission’s decision-making. The  
24 requirement is for APS to “address” the items (“address” is the action verb in the  
25 provision), not for APS to take any action one way or another with respect to the topics  
26 listed. WRA and EDF put it well: “A plain reading of the Settlement Agreement clearly  
27  
28

1 indicates that the factors are not criteria which must be met, but are informational.” Post-  
2 Hearing Brief of WRA and EDF at 8.

3         Moreover, the ACPA arguments with respect to ¶¶ 75(b) and (c) are based on an  
4 unsupported expansion of the terms actually used in the Decision. For example, ¶ 75(b)  
5 requires APS to address its “efforts to secure adequate and reasonably-priced long-term  
6 resources from the competitive wholesale market to meet” its “specific unmet needs.” In  
7 ACPA’s discussion of this paragraph, it entirely ignores the express language and instead  
8 rewrites the provision to its advantage, replacing the “efforts to secure” phrase with a far  
9 narrower prompt about “seeking proposals.” ACPA Initial Post-Hearing Brief at 5. But, as  
10 the ACPA’s own definition of “efforts” makes clear, “efforts to secure” and “seeking  
11 proposals” are two different things: “efforts to secure” allows for far broader procurement  
12 methods than “securing via an RFP” – the interpretation that ACPA puts forth. *See* ACPA  
13 Initial Post-Hearing Brief at 6 (defining “effort” to mean “exertion, endeavor; a product of  
14 effort; active or applied force”). As APS has explained, the Company amply addressed the  
15 “efforts [it took] to secure” its specific unmet resource needs, precisely as contemplated by  
16 ¶ 75(b). *See* APS Initial Post-Hearing Brief at 18-19. Moreover, although ACPA deems  
17 characterizing SCE as a participant in the competitive wholesale market to be  
18 “disingenuous,” it offers no argument as to why only a certain subset of wholesale sellers  
19 (presumably, merchant generators) can be participants in that market. Decision No. 67744  
20 suggests quite the contrary: that a “competitive solicitation” within the meaning of the  
21 Decision very much includes bilateral contracts with non-affiliated entities – whether SCE,  
22 Entegra, or any other business offering wholesale generation capacity for sale into the  
23 market. *See* APS Initial Post-Hearing Brief at 15-16.

24         Second, ACPA’s legal argument is premised on a fundamental misunderstanding of  
25 the need that APS seeks to fill with the proposed transaction. APS’s “specific, unmet need”  
26 is not just a generic baseload resource in the 2016 timeframe. Rather, it is to preserve the  
27 Company’s (and customers’) existing interest in Units 4 and 5 and maintain the coal  
28

1 balance in the APS resource portfolio. This is a need that a natural gas alternative simply  
2 cannot fill. *See* APS Initial Post-Hearing Brief at 18-19. Although APS reiterated this point  
3 throughout the proceeding, ACPA's Initial Post-Hearing Brief wholly failed to address it or  
4 offer any evidence to refute it.

5 Finally, ACPA's long dissertation about why the APS plan does not meet the  
6 "genuine, unanticipated opportunity" exception to the Commission's resource procurement  
7 rules ignores the key point: that the "opportunity" was not just the potential that SCE might  
8 someday sell its interest in Units 4 and 5, but to time the acquisition of that capacity with  
9 the closure of three other APS-owned units so as to resolve issues with the Environmental  
10 Protection Agency and other outstanding uncertainties at the plant, without economically  
11 devastating the Navajo Nation. *See* APS Initial Post-Hearing Brief at 21-25. No legal rule  
12 or decision would thus prevent the Commission from authorizing the proposed transaction,  
13 which, among other things, would give APS customers the opportunity to save millions of  
14 dollars, lower the Company's environmental emissions, and preserve the economic well-  
15 being of the Navajo Nation.

16 Neither does public policy recommend that APS issue an RFP for a resource to  
17 compete with the proposed transaction. *See* APS Initial Post-Hearing Brief at pages 40-43.  
18 Although the ACPA was well aware of what its witness called at hearing APS's "famous"  
19 points for why an RFP should not be required in this case, the ACPA's Initial Post-Hearing  
20 Brief addressed none of them. Instead, with sparse citation to the record, the ACPA  
21 downplayed serious non-economic policy drivers that favor the proposed transaction  
22 (including fuel diversity and Navajo economic impact) and invented "conflicts" of evidence  
23 where none exist to artificially bolster the perceived value of an RFP for this case. The  
24 reality is that there is no "conflict" about the striking economic benefit of the proposed  
25 transaction – not a single shred of evidence exists to rebut the testimony and economic  
26 analyses of APS<sup>2</sup>, Judah Rose, and David Berry, all of which prove that the proposed

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27 <sup>2</sup> APS's analysis was affirmed by Commission Staff and RUCO, although neither conducted an independent  
28 analysis.

1 transaction is an exceptional deal for APS customers. While these witnesses used different  
2 cost assumptions and thus testified to a varying range of estimated savings, all agree with  
3 the critical point: that the SCE transaction economically benefits APS customers by a far  
4 greater value than the most likely alternative. *See* APS Initial Post-Hearing Brief at 2-8.  
5 Neither is there any disconnect between the striking customer value of this transaction and  
6 the fact that APS is the only taker. For many reasons, including the ability to offset the  
7 capacity acquisition with the closing of Units 1-3, APS is singularly situated to benefit from  
8 the deal. *See* APS Initial Post-Hearing Brief at 9-10. Neither would an RFP inform the  
9 Commission whatsoever as to the potential impacts of either coal exposure or natural gas  
10 volatility, as the ACPA implies without explanation in a series of unanswered questions that  
11 serve only to obfuscate the undisputed evidence in the record. *See* ACPA Initial Post-  
12 Hearing Brief at 19-20. In reality, merchants will contract for assets (through a tolling  
13 contract or asset sale), but will not contract for a natural gas commodity – the price of gas  
14 remains subject to the same wide bandwidth of sensitivity depicted in Mr. Dinkel’s  
15 Testimony, and the risk of natural gas price volatility remains. *See* APS Exhibit 8 at 10.

16       Moreover, ACPA’s policy argument in support of an RFP is internally inconsistent.  
17 On the one hand, ACPA insists that APS should issue an RFP “that actually tests the  
18 market” so as to better inform the Commission about the cost of a natural gas alternative.  
19 *See* ACPA Initial Post-Hearing Brief at 19. On the other hand, ACPA’s witness made  
20 abundantly clear that its members would not want APS to use an RFP process “to test the  
21 market” in order to gather information to justify the proposed transaction. Hearing  
22 Testimony of Greg Patterson, Hearing Transcript at 962-63. If it is inappropriate for APS to  
23 use an RFP process to gather data to justify its deal, it is equally inappropriate for APS to  
24 use an RFP process to gather information that may or may not justify its deal (particularly if  
25 all evidence in the record suggests that the deal is so good that no gas proposal can beat it).  
26 The issue is not the nature of the evidence received, but the procedural mechanism used to  
27 receive it. In this case, it is clear that using an RFP for evidentiary purposes as ACPA  
28

1 proposes would, among other things, fail to produce evidence that supports a natural gas  
2 alternative, waste bidders' time and money, damage the Company's credibility with the  
3 market, and further increase the risk that the transaction will fall through. *See* APS Initial  
4 Post-Hearing Brief at 40-42. For all of these reasons, it makes little sense for APS to  
5 conduct an RFP unless the Commission has first determined not to authorize the proposed  
6 transaction.

7 Finally, the "prudence" specter that ACPA raises with respect to the proposed  
8 transaction is both premature and off the mark. All resource options have risks, coal and  
9 natural gas alike, which is why resource diversity is so critically important. *See* APS Initial  
10 Post-Hearing Brief at 10-12. This transaction is not about acquiring more coal and  
11 exposing customers to greater risk – it is about maintaining the existing coal generation in  
12 APS's resource portfolio and making it more environmentally friendly, thus mitigating the  
13 risk attendant to coal and all other generation resources. After APS closes Units 1-3 to  
14 offset the increase in generation acquired from SCE, APS will have only a marginal (and  
15 unavoidable) 179 MW of additional coal in its resource portfolio – coal that is "cleaner" and  
16 highly cost-effective for APS customers, even considering all known and anticipated  
17 environmental compliance costs. *See* APS Initial Post-Hearing Brief at 2-4; Post-Hearing  
18 Brief of WRA and EDF at 3. And, notwithstanding that additional 179 MW, the percentage  
19 of coal as part of APS's overall energy mix actually decreases between now and 2017, from  
20 39% to 33%, reflecting the increasing amount of renewable energy and energy efficiency in  
21 the Company's resource portfolio. In short, nothing in the proposed transaction "over-  
22 exposes" APS customers to coal – instead, the Company will continue to rely on a moderate  
23 amount of coal as a cost-effective baseload resource that supports increasing investment in  
24 renewable and other intermittent resources and reduces the risk of too heavy a reliance on  
25 natural gas. An RFP is not needed to know that this acquisition is a good deal that makes  
26 good sense for APS and its customers.

1 **III. THE SIERRA CLUB'S ARGUMENTS IGNORE AND MISCHARACTERIZE**  
2 **THE EVIDENCE IN THE RECORD.**

3 The arguments in Sierra Club's Post-Hearing Opening Brief are premised on an  
4 incurable factual inaccuracy: that the APS economic analysis focused only on certain costs  
5 associated with the proposed transaction to the exclusion of others, and that "APS should  
6 have conducted a more robust analysis to support its request to increase its exposure to  
7 coal." Post-Hearing Opening Brief of Sierra Club at 5. Leaving aside the fact that the  
8 proposed transaction only marginally increases the amount of coal in APS's fuel mix and  
9 generally substitutes "clean" coal for "dirty" coal, *see infra* at page 7, had Sierra Club  
10 focused for even a moment on the present value revenue requirement analysis that APS  
11 included in its direct case and referenced throughout the hearing, it would have realized the  
12 fallacy of its position. The record is very clear that the upwards of \$500 million present  
13 value revenue requirement savings estimate to which APS testified was based on a  
14 comprehensive economic sensitivity analysis that included all of the known and anticipated  
15 costs associated with continuing to run Four Corners Units 4 and 5, including (but not  
16 limited to) those resulting from the regulatory areas identified on pages 5 and 6 of the Sierra  
17 Club's Post-Hearing Brief. *See* APS Initial Post-Hearing Brief at 2-3.

18 For whatever reason, the Sierra Club has never focused on that "robust" revenue  
19 requirement analysis (the most comprehensive of the three analyses presented in the  
20 Company's Application). Instead, in its Direct Testimony, the Sierra Club tried to  
21 undermine the Company's levelized life cycle cost comparison, which attempted critique  
22 was proven wrong because of material analytical errors by the Sierra Club's witness. *See*  
23 APS Initial Post-Hearing Brief at 6-7. Now, in its Post-Hearing Brief, the Sierra Club turns  
24 to the Company's Capital Cost comparison – an analysis that, by definition, focuses only on  
25 capital costs to the exclusion of O&M and other costs. Despite any trumped up confusion  
26 over what costs may or may not have been included in the Company's Capital Cost  
27 comparison, the evidence is clear that the three more comprehensive economic analyses in  
28 the record – those independently performed by APS, Judah Rose, and David Berry – all

1 took into account future environmental regulations and other anticipated costs at Units 4  
2 and 5 and *still* showed that the proposed transaction is a striking economic benefit to APS  
3 customers. *See* APS Initial Post-Hearing Brief at 2-3; Post-Hearing Brief of WRA and EDF  
4 at 3. Existing evidence thus already provides the Commission with analyses that “reflect a  
5 multi-pollutant approach to evaluating the known and likely costs of continued operation  
6 and retrofit, rather than considering one regulation at a time,” which is what the Sierra Club  
7 purports to seek. Post-Hearing Opening Brief of Sierra Club at 11. No further analysis or  
8 consideration of alternative comparative resources is needed – particularly when the only  
9 evidence on point proves that the Sierra Club’s alternatives are economically inferior and,  
10 with respect to some, operationally implausible. *See* APS Initial Post-Hearing Brief at 7.

11         Second, the Sierra Club opines for the first time in its brief on the requirements of  
12 the “self-build” provisions of Decision No. 67744, echoing to some extent the flawed logic  
13 of ACPA. Two specific points warrant additional refutation. First, there is no evidence to  
14 support the allegation that APS “underutilizes” the Pinnacle West Energy Corporation  
15 (“PWEC”) generating units. To the contrary, these natural gas units are dispatched when  
16 economic to fill existing resource needs. One need not run these units into the ground at  
17 maximum capacity to realize customer value. Second, despite the Sierra Club’s suggestion  
18 otherwise, the lack of an RFP in this case does not convert an arms-length, hotly negotiated  
19 contract between two sophisticated business entities into a “backroom deal” or otherwise  
20 evidence anti-competitive behavior. *See* Sierra Club Post-Hearing Opening Brief at 9.  
21 Indeed, a bilateral contract with a non-affiliate – the nature of APS’s Asset Purchase  
22 Agreement with SCE – was an approved form of “competitive solicitation” at the time  
23 Decision No. 67744 was rendered and remains an acceptable procurement method. *See*  
24 APS Initial Post-Hearing Brief at 16. As a general matter, given the Sierra Club’s “Beyond  
25 Coal” agenda in this proceeding (highlighted again in its closing plea for the Commission to  
26 “make every effort to move its regulated utilities beyond coal as quickly as possible”), the  
27  
28

1 Sierra Club's support for an RFP here is itself evidence that an RFP risks killing the deal –  
2 precisely the Sierra Club's objective.

3 Finally, although the contract with SCE has a relatively short window for approvals,  
4 there is no evidence that the negotiations resulting in the contract were "rushed" or "hasty"  
5 in any way, as the Sierra Club suggests. *See, e.g.,* Post Hearing Opening Brief of Sierra  
6 Club at 9. Far from it – the contract is the product of almost one year of careful planning,  
7 comprehensive analyses, and long negotiations. APS customers will receive the benefit.

8 **IV. NEITHER STAFF NOR RUCO HAS PRESENTED A PERSUASIVE**  
9 **REASON WHY THE REQUESTED ACCOUNTING ORDER SHOULD BE**  
10 **LIMITED**

11 Both Staff and RUCO agree that APS should be granted an accounting order to  
12 mitigate the cost/benefit mismatch each concede results from the proposed transaction. *See*  
13 Staff Closing Brief at 10-19; RUCO Opening Brief at 12-14. Nevertheless, as explained in  
14 APS's Initial Post-Hearing Brief and again below, these parties would limit the scope of  
15 that accounting order for inexplicable reasons and in different ways, all of which undermine  
16 the purpose of the deferral mechanism that Staff and RUCO agree to be appropriate.

17 ***A. Deferral of a Return on the Company's \$294 Million Investment Is***  
18 ***not the Same as Earning a Return on Deferred Costs***

19 APS often found significant confusion on the part of both Staff and RUCO's  
20 recommendations over the distinction between what "return" would and would not be  
21 allowed in the accounting order. This confusion appears to continue in the post-hearing  
22 briefs.<sup>3</sup> To be clear, there is a significant difference between deferring the cost needed to  
23 finance the \$294 million purchase price and deferring a return that is applied to the deferral  
24 balance (including the deferred capital costs, O&M, taxes, and depreciation) – a distinction

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25 <sup>3</sup> In its Closing Brief, for example, Staff appears to recognize that there are two distinct concepts involved  
26 with the Company's deferral request, but confuses those concepts throughout its discussion such that its  
27 recommendation is somewhat difficult to follow. It writes, for example, that "APS is seeking to include in  
28 its deferral a *carrying cost applied to all other deferrals and the compounded value of those carrying costs.*"  
Staff Closing Brief at 15 (emphasis supplied). This is unclear and likely untrue. Precisely, APS seeks to  
include in the deferred balance the financing cost required to raise the money to buy the plant, in addition to  
O&M, depreciation, decommissioning and coal reclamation costs, and taxes. It also seeks to apply a return  
to that total deferral balance year over year.

1 that was at the heart of the disagreement between the parties in both the PV-III and  
2 Sundance proceedings.

3 Although “deferral of a return” and “a return on a deferral” both use the words  
4 “return” and “deferral,” they are in fact quite distinct concepts. “Deferral of a return” on  
5 APS’s \$294 million investment in Four Corners Units 4 and 5 simply recognizes that the  
6 debt APS must incur and the equity funds used to acquire SCE’s interest in Four Corners  
7 have very real costs to the Company – costs that exceed all the other non-fuel costs of  
8 owning and operating the increased share of Four Corners combined. A “return on a  
9 deferral” recognizes that the new investment in Four Corners goes beyond the purchase  
10 price and extends to the money needed to operate that plant and pay taxes on it. Because  
11 the revenue requirements associated with the transaction are not yet in rates, APS will need  
12 to secure debt and equity capital to cover all of these expenses until the end of its next rate  
13 case. Applying a cost of money to the deferral balance year after year (essentially  
14 compounding the return) fully addresses the mismatch.

15 To depict the difference, assume an investment of \$100, operating costs, depreciation  
16 and property taxes of \$10 and a pre-tax cost of capital of 10%. If APS is permitted to defer  
17 the cost of capital required for the \$100 investment, it would defer \$20 in the first year [ $\$10$   
18  $+ (10\% \times \$100) = \$20$ ]. If APS is permitted to earn a return on that \$20 deferral in year  
19 two, its deferral for that second year would be \$22 (the same \$20 as in year one plus  $10\% \times$   
20 the \$20 deferred in year one). If no return is permitted on deferred costs, the deferral would  
21 be a flat \$20 per year.<sup>4</sup>

22 The Company strongly feels that a return should be applied to the deferred costs.  
23 These deferred costs have to be financed by APS every bit as much as will the acquisition  
24 price of Four Corners itself. The cost to APS for financing such deferrals (the \$2 in the  
25 simple example above) is \$3 million in year one, \$9 million in year two and increases by  
26 roughly \$6 million per year until the SCE acquisition is included in the Company’s rate

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27 <sup>4</sup> Normally, the return on a deferred balance is calculated monthly, just like AFUDC, but APS is simplifying  
28 the mathematics to make its point.

1 base. But even these amounts are dwarfed by the simple financing costs required on the  
2 \$294 million acquisition price (the \$10 in the example above). APS will incur capital costs  
3 of \$37.7 million in year one to pay for an asset from which customers will receive an  
4 immediate \$40 million per year fuel cost savings and \$500 million present value savings  
5 over its remaining life. If that \$37.7 million cannot be deferred, APS will never be able to  
6 recover it. The mismatch that all agree exists in this case would be less than half remedied.  
7 There is an old saying that it is better to be approximately right than precisely wrong. If the  
8 Commission believes that APS should not be allowed to earn a return on its deferred costs,  
9 thus rendering the accounting order only “approximately right” in addressing the overall  
10 mismatch, the Commission should nonetheless avoid being “precisely wrong” by denying  
11 APS the ability to recover the primary cost of owning and operating SCE’s share of Four  
12 Corners – the cost of financing \$294 million in debt and equity.

13 For its part, RUCO’s Opening Brief does not seem to quarrel with allowing APS to  
14 include the financing costs that APS will incur to purchase SCE’s share of Units 4 and 5 as  
15 part of the deferral balance, although it does not specifically address the point. Instead,  
16 RUCO focuses entirely on whether APS should be permitted to apply a return to a deferral  
17 balance that includes those financing costs. For example, it notes that “[f]or the most part,  
18 the Company would agree with the applicable and relevant conditions listed above with the  
19 exception of the condition which denied the company the ‘cost of money’ *applied to any*  
20 *deferred amounts.*” RUCO Opening Brief at 13 (emphasis supplied). On that same page,  
21 RUCO goes on to state “...*applying a carrying cost to that deferral is not appropriate.*” *Id.*  
22 (emphasis supplied). Finally: “[T]he Commission should reject the Company’s request to  
23 earn a return *on the deferral amounts.*” *Id.* (emphasis supplied). Such language appears to  
24 object only to the Company’s ability to apply a return to the deferral balance, not to defer  
25 the cost of capital required to purchase the plant. This position is consistent with the  
26 hearing testimony of RUCO’s expert witness Dr. Fish, who testified that APS should be  
27 permitted to include at least the debt component of the capital costs required to finance the  
28

1 \$294 million acquisition as part of the deferral balance, explaining that “I do think they  
2 [APS] have a right to recovery of the interest they pay on debt because that’s a fixed  
3 amount.” APS Initial Post-Hearing Brief at 33.

4 But this transaction will not be financed on debt alone. It will be “balance sheet  
5 financed,” using a combination of both debt and equity capital. The cost of capital  
6 associated with equity investment is every bit as real as that associated with debt, and is a  
7 cost that APS must incur if it is to maintain its Commission-authorized capital structure and  
8 meet the equity infusion requirements of its 2009 APS Rate Case Settlement Agreement.  
9 That said, the Commission need not use the pre-tax embedded weighted cost of capital  
10 found in APS’s last rate case, as APS originally proposed; it should apply whatever cost of  
11 capital the Commission adopts in the currently pending APS rate case. There is thus no  
12 principled reason to calculate the cost of capital associated with the SCE acquisition based  
13 just on debt interest costs alone.

14 In the end, there is a significant distinction between a debate about how to measure  
15 the cost of capital applied to the plant balance (*i.e.*, the weighted average cost of capital  
16 approved in the Company’s next rate case versus one based solely on the cost of debt) and a  
17 debate about whether the cost of capital should be disregarded entirely and eliminated from  
18 the deferral authorization. The Commission has *never* chosen the latter option when ruling  
19 on accounting order requests such as that before it today, nor has any other regulatory  
20 commission in the country as far as APS can tell. To do so now, based on no reasonable  
21 justification, would be wholly arbitrary. Arbitrarily requiring APS to take a multi-million  
22 dollar revenue hit on an acquisition that will immediately save customers \$40 million per  
23 year in fuel costs and \$500 million in present value revenue requirements in the long run is  
24 hardly fair or equitable.

1           **B.    *APS's Request to Defer a Return on the Company's Nearly \$300***  
2           ***Million Investment Satisfies Each of Staff's Claimed Criteria for the***  
3           ***Granting of an Accounting Order***

4           In its Closing Brief, Staff contends that there are three criteria for granting an  
5           accounting order: (1) irreparable harm; (2) significant inequity; and (3) relative costs and  
6           benefits to customers. *See* Staff Closing Brief at 11-12. Putting aside the lack of citation to  
7           any authority supporting this standard, APS's request to defer the financing costs on the  
8           acquisition amount satisfies each of these criteria.

9           First, no witness has disagreed that, absent an accounting order that allows APS to  
10          defer the capital costs required on the Company's nearly \$300 million investment in SCE's  
11          share of Four Corners, the opportunity to recover such costs will be lost forever. The  
12          inability to rectify in the future a present harm is literally the legal definition of "irreparable  
13          harm". *See* Legal.Com at <http://dictionary.law.com>.

14          Second, the same "significant inequity" from the proposed transaction that caused  
15          Staff to recommend a partial deferral remains if financing costs are not included in the  
16          deferral authorized – the inequity would be only partially addressed. But the same reasons  
17          why Staff agrees that it is inequitable for APS to bear 100% of the non-fuel cost of owning  
18          and operating the increased share of Four Corners while customers receive virtually all of  
19          the benefits (*see* Staff Closing Brief at 13) apply equally to the 53% of the requested costs  
20          that Staff would disregard in a cost deferral order as to the 47% of such costs that Staff is  
21          willing to recognize. Staff explains its disparate treatment of capital costs compared to  
22          other costs of owning and operating SCE's share of Four Corners in an inexplicable  
23          footnote to its Closing Brief, which reads: "Staff does not believe that the carrying costs of  
24          owning should be included in an accounting order *since they are recoverable in a rate*  
25          *case.*" Staff Closing Brief at 16 (emphasis supplied). That fact hardly distinguishes capital  
26          carrying costs from O&M, depreciation, property taxes, etc., all of which are equally  
27          "recoverable in a rate case," and all of which Staff agrees should be authorized for deferral.  
28          As noted above, if capital costs are not included in the deferral order, APS will have  
            permanently lost the opportunity to recover those costs prior to the end of its next rate case.

1           The relative costs and benefits to customers are also clear. The transaction requires  
2 APS to pay \$294 million, with annual financing costs of more than \$37 million (more than  
3 half of the total \$70 million requested deferral balance). And, through the operation of the  
4 PSA, it will also immediately save APS customers up to \$40 million in fuel savings per year  
5 for the next 26 years (2012-2038). APS should not have to absorb \$37 million of costs any  
6 more than it should have to absorb the other required costs until the asset is reflected in  
7 rates, particularly when customers are immediately allowed an almost equivalent savings  
8 benefit. In none of the previous accounting orders granted for APS by the Commission was  
9 the imbalance between costs and benefits as striking as is the case with this transaction.

10           Staff characterizes the loss of the ability to defer over \$37 million of annual return on  
11 the Company's \$294 million investment as a mere "lost opportunity" that can somehow be  
12 compensated for by non-existent growth, the retirement of other assets and unspecified  
13 "operating efficiencies." See Staff Closing Brief at 11. But if new investments could so  
14 easily be financed, there would be little need to ever include them in rates. The real world  
15 is a far different place where raising large sums of capital comes at a price – in this case,  
16 over \$37 million per year. And the real "lost opportunity" that could result if Staff and  
17 RUCO's recommendation is adopted and APS therefore foregoes the purchase of SCE's  
18 share of Units 4 and 5 will be that of APS customers, who risk losing the half a billion  
19 dollars in present value savings, and the Navajo Nation, who may lose hundreds of jobs and  
20 most of its revenue.

### 21           **C.    *Miscellaneous Accounting Order Issues***

#### 22                   **1.    Sundance Conditions**

23           RUCO continues to argue that the "applicable and relevant" provisions of the  
24 Sundance order should be engrafted on any deferral order. See RUCO Opening Brief at 13.  
25 The Company addressed these conditions in its Initial Brief, and APS believes that the  
26 conditions imposed on the Sundance transaction by Decision No. 67504 were tailored to  
27 that situation and should not be imposed on this completely different transaction. See APS  
28

1 Initial Post-Hearing Brief at 37-38. Indeed, it is significant that Staff itself did not  
2 recommend the same conditions it had proposed in the Sundance proceeding.

3 **2. Four Corners Units 1-3**

4 The potential for overlap between an accounting order covering Units 4 and 5 while  
5 APS continues to recover the costs of Units 1-3, including a return on its residual value (the  
6 units are largely depreciated), is addressed in just one sentence in Staff's brief. *See* Staff  
7 Closing Brief at 18. As noted in the Company's Initial Post-Hearing Brief, the pending  
8 APS rate case contains a proposal that would resolve the issue of the regulatory treatment of  
9 Units 1-3 going forward. *See* APS Initial Post-Hearing Brief at 35-36. The Commission  
10 should not prejudge that rate case outcome by either offsetting the capital carrying cost of  
11 Units 1-3 against the far larger costs of SCE's share of Units 4 and 5 or using the former as  
12 a reason to deny deferral of the latter.

13 **3. Language in Accounting Order**

14 Staff continues to propose the use of vague and untested language concerning the  
15 future inclusion in rates of any deferred amounts. *See* Staff Closing Brief at 19. APS again  
16 reminds the Commission that the purpose of an accounting order is to prevent the costs  
17 being deferred from being "written off" before the Commission can consider their inclusion  
18 in rates. That, in turn, requires a crispness of language that clearly evidences that intent.

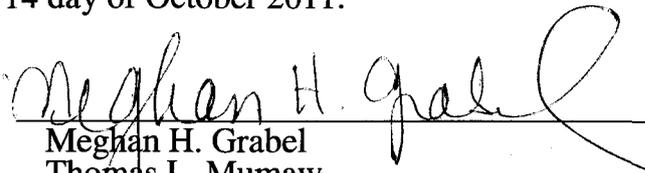
19 As an alternative, Staff proposed language from the first ordering paragraph in  
20 Decision No. 67504. *See* Staff Closing Brief at 20. That is acceptable to the Company so  
21 long as the Commission adds the third ordering paragraph from that same order:

22 IT IS FURTHER ORDERED that the accumulated deferred balance  
23 associated with all amounts deferred pursuant to this Decision will be  
24 included in cost of service for rate-making purposes in Arizona Public  
25 Service Company's next general rate case. Nothing in this Decision  
26 shall be construed to limit this Commission's authority to review such  
27 balance and make disallowances thereof due to imprudence, errors or  
28 inappropriate application of the requirements of this Decision.

1 **V. CONCLUSION**

2 At the end of the day, all parties recognize that, faced with a complex situation with  
3 many moving parts, APS has found a solution with broad public benefits: to customers, to  
4 the environment, and to the Navajo Nation. Many factors external to the Commission still  
5 threaten the deal. To improve the likelihood that this transaction will move forward, APS  
6 needs this Commission's full support. APS respectfully requests that the Commission grant  
7 the requests the Company needs to make these benefits happen.

8 **RESPECTFULLY SUBMITTED** this 14 day of October 2011.

9  
10 By: 

11 Meghan H. Grabel  
12 Thomas L. Mumaw

13 Attorneys for Arizona Public Service Company

14 ORIGINAL and thirteen (13) copies  
15 of the foregoing filed this 14 day of  
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